80-1303

Office-Supreme Court, U.S.
FILED
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ALEXANDER L. STEVAS,
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No. _____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

THE POTOMAC EDISON COMPANY, *Appellant*,

v.

COMMONWEALTH OF PENNSYLVANIA, *Appellee*.

On Appeal From The Supreme Court Of Pennsylvania

JURISDICTIONAL STATEMENT

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QUESTION PRESENTED

Did Pennsylvania courts construe and apply Article VI of the Pennsylvania Tax Reform Code of 1971, as amended, to deprive Appellant equal protection of law, in violation of Section 1 of the Fourteenth Amendment to the Constitution of the United States, by adjudging Appellant's claim to the manufacturing exemption from Pennsylvania franchise tax by a different definition of the term "manufacturing" than uniformly applied for over 50 years to all other taxpayers claiming the exemption, since no basis exists for the difference and the Pennsylvania courts stated no reason for the difference?

TABLE OF CONTENTS

	PAGE
QUESTION PRESENTED	i
OPINIONS BELOW	1
GROUNDS OF JURISDICTION	2
STATEMENT OF THE CASE	4
Litigation History	4
Facts	5
Manner of Raising Federal Questions	9
FEDERAL QUESTIONS ARE SUBSTANTIAL	13
The Act as Construed by The Supreme Court of Pennsylvania and Applied to Appellant Violates the Equal Protection Clause Because The Supreme Court of Pennsylvania Failed to Adjudge Appellant's Claim to the Manufacturing Exemption by the Standard Applied to All Other Taxpayers Who Claimed the Manufacturing Exemption Either From Franchise Tax or Capital Stock Tax	14
Appellee's Discriminatory Enforcement of the Manufacturing Exemption Against Appellant Under an Otherwise Constitutional Statute Violates the Equal Protection Clause	23
CONCLUSION	26
APPENDIX A — Order and Judgment of the Supreme Court of Pennsylvania	1a
APPENDIX B — Order of the Supreme Court of Pennsylvania on Appellant's Application for Reargument	3a
APPENDIX C — Opinion and Final Order of the Commonwealth Court of Pennsylvania	5a
APPENDIX D — Notices of Appeal	17a
APPENDIX E — Relevant Provisions of Article VI of the Tax Reform Code of 1971	21a
APPENDIX F — Listing of Cases	23a

PREVIOUS PAGE WAS BLANK

TABLE OF AUTHORITIES

CASES: PAGE

American Oil Company v. *Neill*, 380 U.S. 451 (1965) 21

Colgate v. *Harvey*, 296 U S. 404 (1935) 3, 22, 23

Commonwealth v. *Budd Company*, 379 Pa. 159, 108 A.2d 563 (1954) 20

Commonwealth v. *Deitch Company*, 449 Pa. 88, 295 A.2d 834 (1972) 14, 17

Commonwealth v. *McCready Rodgers Co.*, 316 Pa. 195, 174 A.395 (1934) 16

Commonwealth v. *Perfect Photo, Incorporated*, 29 Pa. Commonwealth Ct. 316, 371 A.2d 580 (1977) 16

Commonwealth v. *Philadelphia Electric Company*, 21 Pa. Commonwealth Ct. 593, 347 A.2d 494 (1975), reversed on other grounds 427 Pa. 530, 372 A.2d 815 (1977) 20

Cumberland Coal Co. v. *Board of Revision, Etc.*, 284 U.S. 23 (1931) 4, 23, 24, 25

Golden Triangle Broadcasting, Inc. v. *City of Pittsburgh*, 31 Pa. Commonwealth Ct. 547, 377 A.2d 839 (1977), affirmed 483 Pa. 525, 397 A.2d 1147 (1978), reargument den. (1979) 20

Liggett Co. v. *Lee*, 288 U.S. 517 (1935) 3, 22, 23

Royster Guano Co. v. *Virginia*, 235 U.S. 412 (1920) .. 3, 20, 21

Sioux City Bridge Company v. *Dakota County*, 260 U.S. 441, (1923) 4, 23, 24

Southern Railway Co. v. *Greene*, 216 U.S. 400 (1910). 3, 21, 23

Steward Dry Goods Co. v. *Lewis*, 294 U.S. 550, (1935), rehearing denied 295 U.S. 768, (1935)..... 3, 22, 23

Sunday Lake Iron Co. v. *Wakefield*, 247 U.S. 350 (1918)..... 4, 23, 24

Welch v. *Henry*, 305 U.S. 134 (1938) 20

Table of Authorities Continued

CASES: PAGE

Wheeling Steel Corp. v. *Glander*, 337 U.S. 562 (1949)... 3

WHYY, Inc. v. *Borough of Glassboro*, 393 U.S. 117 (1968)..... 3, 22, 23

CONSTITUTION:

Section 1 of the Fourteenth Amendment to the Constitution of the United States ..... i, 2, 3, 4, 20, 21, 22

PENNSYLVANIA STATUTES:

Article VI of the Pennsylvania Tax Reform Code of 1971, Act of March 4, 1971, P.L. 88-93, §§601 et seq., 72 P.S. §§7601 et seq..... i, 2, 4, 8, 14, 19

Act of August 31, 1971, P.L. 362 §5 19

Act of July 1, 1978, P.L. 594 19

The Fiscal Code, Act of April 9, 1929, P.L. 343, 72 P.S. §1104 2

FEDERAL STATUTES:

28 U.S.C. §1257(2) 2

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OCTOBER TERM, 1980

No. _____

THE POTOMAC EDISON COMPANY, *Appellant*,

v.

COMMONWEALTH OF PENNSYLVANIA, *Appellee*.

On Appeal From The Supreme Court Of Pennsylvania

JURISDICTIONAL STATEMENT

OPINIONS BELOW

The *per curiam* order of the Supreme Court of Pennsylvania is not yet reported. The Supreme Court of Pennsylvania delivered no opinion in this case. The order and its related judgment are appended hereto at pages 1a and 2a.

The only opinion delivered in this case was delivered by the Commonwealth Court of Pennsylvania. The opinion of the Commonwealth Court of Pennsylvania is reported at 50 Pa. Commonwealth Ct. _____, 411 A.2d 1287 (1980), and is appended hereto at pages 5a-13a.

GROUNDS OF JURISDICTION

This case arose by *de novo* appeal to the Commonwealth Court of Pennsylvania, pursuant to Section 1104 of The Fiscal Code of the Commonwealth of Pennsylvania, Act of April 9, 1929, P.L. 343, 72 P.S. §1104, as amended, from the various actions of Pennsylvania taxing officials in refusing to allow Appellant the manufacturing exemption from Pennsylvania franchise tax for calendar year 1972. The Commonwealth Court of Pennsylvania affirmed the state taxing officials' denying Appellant the exemption by final order and judgment entered on April 10, 1980.

By *per curiam* order entered on November 3, 1980, without opinion, the Supreme Court of Pennsylvania, affirmed on appeal the decision of the Commonwealth Court of Pennsylvania. Appellant timely filed an application for reargument which the Supreme Court of Pennsylvania denied by *per curiam* order entered on December 18, 1980. The notice of appeal to the Supreme Court of the United States was filed on January 26, 1981 in the Supreme Court of Pennsylvania and on January 22, 1981 in the Commonwealth Court of Pennsylvania.

The jurisdiction of the Court is invoked under 28 U.S.C. §1257(2). This appeal questions Article VI of the Pennsylvania Tax Reform Code of 1971, Act of March 4, 1971, P.L. 88-93, §§601 *et seq.*, 72 P.S. §§7601 *et seq.* (hereinafter the "Act"), as construed by Appellee and as applied by Appellee to Appellant on the ground that such construction and application are repugnant to the Constitution of the United States. Appellant contends that construing and applying the Act to deny Appellant the manufacturing exemption from 1972 Pennsylvania franchise tax violate the equal protection clause of the Fourteenth Amendment of the Constitution of the

United States. Pennsylvania appellate courts construed the Act to apply to Appellant a different definition of the term "manufacturing" than the Pennsylvania appellate courts applied to all other taxpayers claiming the exemption, without voicing any reason for the difference. No reason for the difference exists. The Supreme Court of Pennsylvania's upholding the Act as so applied to Appellant, is repugnant to the Constitution of the United States.

The equal protection clause of the Fourteenth Amendment applies to taxes enacted, imposed and administered by the states. *Wheeling Steel Corp.* v. *Glander*, 337 U.S. 562 (1949). In the following cases, the United States Supreme Court held that state taxes upheld by state courts were unconstitutional, violating the equal protection clause of the Fourteenth Amendment to the United States Constitution:

WHYY, Inc. v. *Borough of Glassboro*, 393 U.S. 117 (1968), reversing 91 N.J. Super. 269, 219 A.2d 893 (1966);

Wheeling Steel Corp. v. *Glander, supra*, reversing 150 Ohio St. 229, 80 N.E. 2d 863 (1948);

Colgate v. *Harvey*, 296 U.S. 404 (1935), reversing 107 Vt. 28, 175 A.352 (1934);

Steward Dry Goods Co. v. *Lewis*, 294 U.S. 550, (1935), rehearing denied 295 U.S. 768 (1935), reversing 7 F. Supp. 438 (1933);

Liggett Co. v. *Lee*, 288 U.S. 517 (1935), reversing 104 Fla. 609, 141 So. 153 (1932);

Royster Guano Co. v. *Virginia*, 253 U.S. 412 (1920), reversing the Supreme Court of Virginia;

Southern Railway Co. v. *Greene*, 216 U.S. 400 (1910), reversing 160 Ala. 396, 49 So. 404 (1909).

In the following cases, the United States Supreme Court held that state courts' discriminatory enforcement or application of an otherwise valid taxing statute violated the equal protection clause of the Fourteenth Amendment:

Cumberland Coal Co. v. *Board of Revision, Etc.*, 284 U.S. 23 (1931), reversing 302 Pa. 179, 152 A.755 (1930);

Sioux City Bridge Company v. *Dakota County*, 260 U.S. 441 (1923), reversing 105 Neb. 843, 182 N.W. 485 (1921);

Sunday Lake Iron Co. v. *Wakefield*, 247 U.S. 350 (1918), reversing 186 Mich. 626, 153 N.W. 14 (1915).

The revelant portions of Article VI of the Pennsylvania Tax Reform Code of 1971, as amended, are appended hereto at pages 21a-22a.

STATEMENT OF THE CASE

Litigation History. This case is an appeal from the order of the Supreme Court of Pennsylvania denying Appellant's claim to the manufacturing exemption from franchise tax for calendar year 1972. Appellee's taxing officers settled Appellant's 1972 franchise tax, disallowing the manufacturing exemption. Appellant challenged this settlement by timely filing a petition for resettlement with Appellee's Department of Revenue and Department of the Auditor General which refused the petition for resettlement. Appellant appealed the refusal of the petition for resettlement by timely filing a petition for review with Appellee's Board of Finance and Revenue which denied the petition for review by order dated August 27, 1975, with the designee of the State Treasurer dissenting. Thereafter, Appellant timely ap-

pealed the order of the Board of Finance and Revenue to the Commonwealth Court of Pennsylvania.

The Commonwealth Court of Pennsylvania heard the appeal *de novo*, as required by Pennsylvania law. The facts were largely stipulated, and the balance of the record, consisting predominantly of expert testimony proving Appellant's manufacture of electricity, was developed at trial before a judge of the Commonwealth Court sitting without a jury. By order entered March 10, 1980, the Commonwealth Court of Pennsylvania affirmed the order of the Board of Finance and Revenue. Exceptions to the order of the Commonwealth Court of Pennsylvania were filed and dismissed by that Court in its final order entered April 10, 1980. Thereafter, on timely appeal, the Supreme Court of Pennsylvania affirmed the order of the Commonwealth Court of Pennsylvania by *per curiam* order entered November 3, 1980. On November 17, 1980, Appellant timely filed its application for reargument which the Supreme Court of Pennsylvania denied by *per curiam* order entered December 18, 1980. Appellant timely filed its notice appeal to the Supreme Court of the United States in the Supreme Court of Pennsylvania on January 26, 1981 and in the Commonwealth Court of Pennsylvania on January 22, 1981.

The Prothonotary of the Supreme Court of Pennsylvania remitted the Record to the Prothonotary of the Commonwealth Court of Pennsylvania on January 8, 1981.

Facts. Appellant is a Maryland corporation providing electric service to the public only in Maryland. Appellant has charter power to manufacture electricity. Appellant provided no electric service to the public in Pennsylvania. At all times material to this case, Appellant had no service territory or customers in Penn-

sylvania. At all times material hereto, Appellant's only activity in Pennsylvania was its 20% ownership as tenant-in-common in the coal-fired, steam-driven electricity generating power plant at Hatfield's Ferry Power Station (hereinafter the "power plant"), its underlying real property and its electricity output. From its share of the power plant's output, Appellant furnished electric service to its customers in Maryland. The other tenants-in-common with Appellant are Monongahela Power Company and West Penn Power Company.

The power plant is located on the Monongahela River at Mastontown, Greene County, Pennsylvania. The electrical energy manufactured at the power plant is transferred from the electric generating phase circuits at the plant by transmission and distribution lines to the meters of the customers of West Penn Power Company, Monongahela Power Company and Appellant. The power plant was constructed at Mastontown, near an adequate water supply on the Monongahela River and near Pennsylvania's ample coal resources to provide adequate and accessible fuel for the power plant, without having to rely on petroleum imported from foreign nations. The power plant also was located at Masontown near the "load center" in a geographic area convenient to the service territories of Appellant in Maryland, Monongahela Power Company in West Virginia and Ohio and West Penn Power Company in Pennsylvania, thereby minimizing transportation costs for fuel and cost to transmit power over power lines to the customers of the three member companies and their respective service territories.

The construction of large, jointly-owned power plants in Pennsylvania began approximately 15 years ago near Pennsylvania coal resources to meet the growing de-

mand for electrical energy in the mid-Atlantic region. Only six (6) such power plants exist. Ownership of the power plants by several utilities as tenants-in-common makes it possible for small as well as large utilities to participate directly in their benefits. A single, large, multi-owned power plant provides each owner with relatively small increments of capacity on a more orderly and economic basis than is possible through sole ownership of such a plant by one public utility, particularly because of the energy crisis and petroleum shortage. The economies, in both construction and operating costs, inure to the benefit of electricity consumers through lower rates than would otherwise have to be charged. Moreover, such multi-ownership increases reliability of supply and minimizes the owner's risks that result from an extended outage of large units such as a power plant.

Appellant contends that its generating electricity by the coal-fired, steam-driven process at the power plant constitutes manufacturing, which qualifies Appellant for the manufacturing exemption from franchise tax for calendar year 1972. At trial through the expert testimony of Howard B. Hamilton, Ph.D., an electrical engineer registered professionally in Pennsylvania and Ohio and a professor in the Department of Electrical Engineering, University of Pittsburgh, Appellant proved that electricity is manufactured at the power plant by the coal-fired steam-driven process. Dr. Hamilton testified that electricity is a man-made product manufactured at the plant by transforming the raw materials of coal, water and oxygen substantially in form, qualities and adaptability in use into a new and different product — electrical energy. Dr. Hamilton's testimony satisfied *verbatim* the judicial definition of the term "manufacturing".[1]

[1] The definition is quoted *verbatim infra* at 14-15.

(R.169a-172a) Appellee called no witnesses and presented no testimony to rebut Dr. Hamilton's testimony. His opinion that Appellant manufactured electricity at the power plant is uncontroverted.

Article VI of the Act contains the franchise tax, applicable only to foreign corporations, and the capital stock tax, applicable only to Pennsylvania corporations. The capital stock tax is not involved in this appeal. The Act provides the same manufacturing exemption from both taxes. Article VI of the Act, and its predecessor legislation,[2] which pertain to the capital stock tax and the franchise tax, contained no statutory definition of the term "manufacturing". Therefore, the Supreme Court of Pennsylvania judicially defined the term more than 50 years ago. Since then, the General Assembly of the Commonwealth of Pennsylvania amended the franchise tax and the capital stock tax at least 21 times, but never altered the judicial definition of the term "manufacturing" and never enacted a statutory definition for the term.[3] For more than 50 years, Penn-

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[2] A capital stock tax was enacted in 1840 by the Act of June 11, 1940, P.L. 612. This statute contained no manufacturing exemption. A limited manufacturing exemption from capital stock tax was first enacted in 1879 by the Act of June 7, 1879, P.L. 112. Thereafter, succeeding amendments to the capital stock tax legislation expanded the exemption. The franchise tax was enacted in 1935, and applies only to foreign corporations like Appellant. Act of May 16, 1935, P.L. 184. The capital stock tax applies only to domestic, or Pennsylvania, corporations.

[3] By comparison, in 1971, the General Assembly inserted, in the section of the statute containing the manufacturing exemption, exemptions for "processing" and "research and development" and specifically defined those terms, without defining the term "manufacturing". 72 P.S. §7602

sylvania appellate courts and taxing officers applied the same judicial definition to the term "manufacturing" in determining the claims of all corporate taxpayers, domestic and foreign, to the manufacturing exemption, except Appellant. In Appellant's case, the Commonwealth Court of Pennsylvania and the Supreme Court of Pennsylvania, without explanation, failed to apply this definition to Appellant, without overruling the definition. No Pennsylvania Court ever applied the definition of manufacturing in determining the manufacturing exemption from capital stock tax or franchise tax which was applied to Appellant in this case, either before or after this case was decided.

Manner of Raising Federal Questions. Appellant first raised the federal constitutional questions involved in this appeal during the administrative proceedings. Appellant pursued the federal constitutional questions at every stage of judicial review. In its petition for review filed with Appellee's Board of Finance and Revenue, Appellant argued as follows:

> "9. Petitioner [Appellant] therefore avers that the settlement herein complained of and the action of the Department of Revenue and the Department of Auditor General in refusing the Petition for Resettlement are erroneous, illegal and void for the following reasons, among others:
>
> * * *
>
> (f) Section 602(b) of the Tax Reform Code of 1971 imposing Franchise Tax on Petitioner provides in part that the manufacturing exemption contained in 602(a) [relating to manufacturing exemption available to domestic corporations from capital stock tax] shall also apply to foreign corporations and in determining the relevant apportionment factors the numerator of the property fraction shall not

include any property attributable to manufacturing with this Commonwealth. Petitioner's tangible property in Pennsylvania is used exclusively in manufacturing electric power and the value thereof was erroneously included in the numerator of the fraction by the Departments.

* * *

(h) Said Settlement, and the action of the Pennsylvania Department of Revenue and the Pennsylvania Department of Auditor General in refusing the Petition for Resettlement result in an arbitrary and illegal tax, contrary to the provisions of Section 1 of the Fourteenth Amendment of the United States Constitution and Article 1, Section 9 of the Pennsylvania Constitution.

(i) Said Settlement, in any event, is greater than the Franchise Tax liability imposed against other taxpayers similarly situate for a comparable period of taxation. Hence, said Settlement is contrary to Section 1 of the Fourteenth Amendment to the United States Constitution and Article VIII, Section 1 of the Pennsylvania Constitution.

(j) Upon all the facts and under the principles above stated, the instant Settlement and the action of the Pennsylvania Department of Revenue and the Pennsylvania Department of Auditor General in refusing the Petition for Resettlement are erroneous, illegal and unconstitutional."

Appellant raised the same arguments nearly *verbatim* in its petition for resettlement filed with Appellee's Department of Revenue and Department of Auditor General. Neither the Board of Finance and Revenue nor the Department of Revenue and the Department of Auditor General issued any opinion in refusing Appellee's petition for review and denying its petition for resettlement.

In appealing to the Commonwealth Court of Pennsylvania from the order of the Board of Finance and Revenue, Appellant included the federal questions in its specification of objections and exceptions, arguing:

> "8. . . . The Order of the Board of Finance and Revenue herein complained is erroneous, illegal and void, for the following specific reasons, among others:
>
> * * *
>
> (c) Section 602(b) of the Tax Reform Code of 1971 imposing Franchise Tax on Appellant provides in part that the manufacturing exemption contained in Section 602(a) shall also apply to foreign corporations and in determining the relevant apportionment factors the numerator of the property fraction shall not include any property attributable to manufacturing within this Commonwealth. Appellant's tangible property in Pennsylvania is used exclusively in manufacturing electric power, and the value thereof was erroneously included in the numeration of other fraction by the Departments.
>
> * * *
>
> (e) Said Settlement and the action of the Pennsylvania Department of Revenue and the Pennsylvania Department of Auditor General in refusing the Petition for Resettlement and the action of the Board of Finance and Revenue in refusing the Petition for Review result in an arbitrary and illegal tax, contrary to the provisions of Section 1 of the Fourteenth Amendment of the United States Constitution and Article 1, Section 9 of the Pennsylvania Constitution.
>
> (f) Said Settlement, in any event, is greater than the Franchise Tax liability imposed against

> other taxpayers similarly situate for a comparable period of taxation. Hence, said Settlement is contrary to Section 1 of the Fourteenth Amendment to the United States Constitution and Article VIII, Section 1, of the Pennsylvania Constitution.
>
> (g) Upon all the facts and under the principles above stated, the instant Settlement and the action of the Pennsylvania Department of Revenue and the Pennsylvania Department of Auditor General in refusing the Petition for Resettlement, and the action of the Board of Finance and Revenue in refusing the Petition for Review are arbitrary, capricious, erroneous, illegal and unconstitutional."

The Commonwealth Court of Pennsylvania erroneously departed from the judicial definition of the term "manufacturing", affirming the order of the Board of Finance and Revenue. Appellant excepted to the decision of the Commonwealth Court of Pennsylvania, but that Court overruled the exceptions and entered a final order in favor of Appellee. Without issuing an opinion, the Supreme Court of Pennsylvania affirmed the Commonwealth Court of Pennsylvania. Thereafter, Appellant timely filed with the Supreme Court of Pennsylvania its application for reargument on several grounds, including constitutional issues. In its application for reargument, Appellant contended, *inter alia*,:

> "4. As a matter of law and fundamental fairness, Appellant is entitled to have its appeal adjudged by the same definition of the term "manufacturing" as consistently applied by your Honorable Court to past tax litigants and as repeatedly accepted by the General Assembly in sessions, spanning more than 50 years. By failing to adjudge Appellant's claim according to its judicial definition of "manufacturing", your Honorable Court failed to apply

> uniformly the manufacturing exemption from franchise tax in violation of Article IX, Section 1 of the Pennsylvania Constitution, and also deprived Appellant equal protection of law in violation of Section 1 of the Fourteenth Amendment to the United States Constitution. Affirming the Order of the Commonwealth Court imposes a greater franchise tax liability against Appellant than against other taxpayers whose franchise tax liability, and exemption therefrom under the manufacturing exemption, were previously adjudged by your Honorable Court under its judicial definition of 'manufacturing'."

The Supreme Court of Pennsylvania refused to hear further argument and denied the application for reargument, without issuing an opinion.

FEDERAL QUESTIONS ARE SUBSTANTIAL

This appeal involves the denial of equal protection of law to Appellant in two respects — the refusal to adjudge Appellant's claim to the manufacturing exemption by the standard applied to all other taxpayers who claimed the manufacturing exemption either from franchise tax or capital stock tax and also the discriminatory construction and enforcement of the Act, as so applied against Appellant, while other taxpayers claiming the manufacturing exemption received the benefit of constitutional construction and enforcement of the Act. By refusing to adjudge Appellant's claim to the manufacturing exemption by the standard applied to all other taxpayers seeking the exemption, Pennsylvania appellate courts and taxing officers acted arbitrarily and capriciously.

The Act as Construed by The Supreme Court of Pennsylvania and Applied to Appellant Violates the Equal Protection Clause Because The Supreme Court of Pennsylvania Failed to Adjudge Appellant's Claim to the Manufacturing Exemption by the Standard Applied to All Other Taxpayers Who Claimed the Manufacturing Exemption Either From Franchise Tax or Capital Stock Tax.

Article VI of the Act imposes upon foreign corporations doing business in Pennsylvania an annual tax on the value of its capital stock determined according to statutory valuation methods, as allocated to the Commonwealth of Pennsylvania. 72 P.S. §§7601, 7602. This tax is known as the franchise tax. Section 7602(b) of the Act provides that "in determining the relevant apportionment factors the numerator of the property, payroll, or sales factors shall not include any property, payroll or sales attributable to manufacturing . . . activities in the Commonwealth." 72 P.S. §7602(b). This language is known as the "manufacturing exemption" from franchise tax. The Act also provides a manufacturing exemption from capital stock tax. The Act contains no definition of the term "manufacturing" for the purpose of the manufacturing exemption from franchise tax or capital stock tax. Consequently, the term was judicially defined. Pennsylvania taxing authorities and appellate courts applied the same definition of the term "manufacturing" to all taxpayers, except Appellant, claiming the manufacturing exemption from franchise tax or capital stock tax.

In *Commonwealth* v. *Deitch Company,* 449 Pa. 88, 295 A.2d 834 (1972) the Supreme Court of Pennsylvania

summarized the evolution of the judicial definition of the term "manufacturing":

> "This definitional vacuum [the failure of the Act and its predecessor legislation to define the term "manufacturing"] has been filled by a judicial definition of the term which has emerged from a long line of cases extending back over a hundred year's time.
>
> * * *
>
> The meaning of 'manufacturing' has been restated by this court in *Philadelphia School District* v. *Parent Metal Products, Inc.*, 402 Pa. 361, 167 A.2d 257, 258-59 (1961); 'Manufacturing' as used in a legislative enactment is given its ordinary and general meaning. It consists in the application of labor or skill to material whereby the original article is changed into a new, different and useful article: *Commonwealth* v. *Weiland Packing Company*, 292 Pa. 447, 449, 141 Atl. 148 (1928); *Pittsburgh* v. *Electric Welding Company*, 394 Pa. 60, 145 A.2d 528 (1958). Whether or not an article is a manufactured product depends on whether or not it has gone through a substantial transformation in form, qualities and adaptability in use from the original material, so that a new article or creation has emerged: *General Foods Corp.* v. *Pittsburgh*, 383 Pa. 244, 118 A.2d 572 (1955). If there is merely a superficial change in the original materials, without any substantial or well signalized transformation in form, qualities and adaptability in use, it is not a new article or new production: *Commonwealth* v. *Weiland, supra; Pittsburgh* v. *Electric Welding Co., supra*"' 449 Pa. at 92-94, 295 A.2d at 837.

For more than 50 years, Pennsylvania appellate courts have applied *verbatim* this judicial definition of the term "manufacturing" in adjudging the claims of corporate

taxpayers, foreign and domestic, to the manufacturing exemption from franchise tax and capital stock tax. For example, in 1977, the Commonwealth Court of Pennsylvania applied the definition to rule that a photofinisher engaged in developing negative film and making photographic prints therefrom; developing and processing reversal film into color transparencies, consisting of "slides" and "movie" film; and enlarging negatives, slides and photographs was engaged in manufacturing under the Act. Therefore, the Court held these activities exempt from capital stock taxation under the manufacturing exemption. *Commonwealth* v. *Perfect Photo, Incorporated,* 29 Pa. Commonwealth Ct. 316, 371 A.2d 580 (1977). Similarly, in 1934, applying the same judicial definition of the term manufacturing, the Supreme Court of Pennsylvania affirmed a lower court holding that making concrete qualified for the manufacturing exemption from capital stock tax. *Commonwealth* v. *McCready Rodgers Co.,* 316 Pa. 195, 174 A.395 (1934). The cases are a legion.[4]

However, in denying Appellant's claim to the manufacturing exemption, the Commonwealth Court of Pennsylvania, without explanation and without overruling the definition of the term manufacturing, added the following requirements to the judicial definition:

> "The traditional legal concept assumes tangible 'material' as a starting point, and a continuity of existence of that material into the final product.
>
> * * *
>
> Where no molecules of the original raw material survive in the final product, we thus do not have manufacturing in the judicial sense of 'application of labor and skill' to 'material.'" 411 A.2d at 1290, 1291.

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[4] Various representative cases are listed *infra* at pages 23a-24a.

After so departing from the judicial definition, the Commonwealth Court of Pennsylvania held that Appellant's electricity generating activities at the power plant failed to qualify for the manufacturing exemption. 411 A.2d at 1291. The time honored definition applied by the Pennsylvania courts in adjudging claims to the manufacturing exemption contains no reference to "molecules of the original raw material" and no requirement that such molecules "survive in the final product". The judicial definition imposes no such requirements, but contemplates "a *new article or creation*, without referring to or distinguishing among the terms "tangible", "less tangible" or "intangible". *Compare, Deitch, supra* at 14-15. Research reveals that Pennsylvania courts never applied these requirements in adjudging a taxpayer's claim to the manufacturing exemption, either from franchise tax or capital stock tax.

The Commonwealth Court of Pennsylvania deliberately departed from the judicial definition of the term "manufacturing", in order to deny Appellant's claim to the manufacturing exemption. At trial, Appellee offered as evidence its proposed exhibit no. 1 as part of the testimony of a taxing officer. This exhibit purported to list the franchise tax and capital stock tax liability allegedly paid to the Commonwealth of Pennsylvania for tax years 1971 through 1977 by 18 electricity generating companies. The exhibit showed that this tax liability totaled $209,170,853.00 during that period. Appellant properly objected to this testimony and Appellee's proposed Exhibit No. 1 as irrelevant, immaterial and lacking foundation. The Learned Trial Judge reserved ruling on the admissibility of the testimony and the exhibit, noting, however, as follows:

> "THE COURT: What you really consider relevant is to inform the court *how much revenue hinges on*

> *its decision* in this case, to apprise of the importance of the case." (R.241a) (Emphasis added)

In an offer of proof, Appellee's counsel related to the Court that the purpose of this testimony was to show that "under the taxpayer's interpretation of the statute that between twenty-one and thirty-nine million dollars annually would be lost in revenues to the Commonwealth and perhaps over a hundred million over a five-year period." (R.239a). The Commonwealth Court of Pennsylvania erred in failing to expunge these facts from the record and in failing to rule in its opinion that these facts were not pivotal to its decision to deny Appellant's claim to the manufacturing exemption.

In its briefs and its oral arguments before the Commonwealth Court of Pennsylvania and the Supreme Court of Pennsylvania, Appellee, despite Appellant's objections, continued to press its contention that the Commonwealth of Pennsylvania would lose considerable revenues if electricity generating corporations, like Appellant, were granted the manufacturing exemption. In its briefs, Appellant emphasized:

> "The General Assembly never intended to lose the considerable revenues which would be lost if electric generating corporations were granted the manufacturing exemption." Appellee's brief before the Commonwealth Court of Pennsylvania at 47; Appellee's brief before the Supreme Court of Pennsylvania at 39.

In an offer of proof at trial before the Commonwealth Court of Pennsylvania, Appellee's counsel advised that Court:

> "This court may take judicial notice that in that year, 1971, the Commonwealth was in one of its most serious economic and fiscal crises . . . had had

> an unconstitutional deficit of $500,000.000.00 . . . was suspending the manufacturing exemption to generate dollars". (R.238a-239a)[5]

These persistent remarks about the fiscal impact of a decision in this case, despite Appellant's objections, motivated Pennsylvania appellate courts to depart, without explanation, from the time honored judicial definition of the term "manufacturing", without overruling that definition, in order to deny Appellant's claim to the manufacturing exemption thereby avoiding the admittedly adverse fiscal impact on the Commonwealth of Pennsylvania.

As further evidence of the fiscal significance which Appellee attached to Appellant's claim to the manufacturing exemption, Appellee's Department of Revenue introduced into the General Assembly during 1978 legislation amending Article VI of the Act, seeking to restore to the manufacturing exemption from capital stock tax the restriction that the exemption was not available to Pennsylvania corporations which "exercise and enjoy the right of eminent domain" and also seeking to enact for the first time since 1943 that same restriction to the manufacturing exemption from franchise tax. Act of July 1, 1978, P.L. 594. This restriction was deleted by the Act in 1971 as to capital stock tax and by legislation in 1943 as to franchise tax. The 1978 legislation purported to be retroactive to August 31, 1971 or, in the

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[5] By Article VI of the Act, the General Assembly actually suspended the manufacturing exemption from franchise tax and capital stock tax during the period January 1, 1971 through June 30, 1972. By the Act of August 31, 1971, P.L. 362, 389-390, 393 §§5, 8, the General Assembly amended the Act, restoring the manufacturing exemption from franchise tax and capital stock tax, effective July 1, 1972.

alternative, "retroactive to the furthest legal date possible."[6] The 1978 legislation was enacted by the General Assembly after the appeal in this case was filed in an effort to bar the manufacturing exemption claims of electricity generating companies, domestic or foreign, like Appellant, which possess and sometimes exercise the right of eminent domain. The United States Supreme Court infers discrimination in violation of the equal protection clause from a state's amending tax legislation after litigation challenging the tax legislation is commenced. *E.g., Royster Guano Co.* v. *Virginia,* 253 U.S. 412, 416-417 (1920).

The Appellee's fiscal crisis, demonstrated by this legislative history and pressed repeatedly by Appellee during this litigation, despite Appellant's objections, impacted on the courts' decision to deny Appellant's claim to the manufacturing exemption from franchise tax for calendar year 1972, particularly when considered in the context of case law decided by the same Pennsylvania courts observing, albeit *dictum,* that the generation of electricity by whatever method constitutes "manufacturing" in the ordinary meaning of that term. *Commonwealth* v. *Philadelphia Electric Company,* 21 Pa. Commonwealth Ct. 593, 347 A.2d 494 (1975), reversed on other grounds 472 Pa. 530, 372 A.2d 815 (1977); *Golden Triangle Broadcasting, Inc.* v. *City of Pittsburgh,* 31 Pa. Commonwealth Ct. 547, 377 A.2d 839 (1977), affirmed 483 Pa. 525, 397 A.2d 1147 (1978), reargument den. (1979).

[6] Such patently offensive retroactivity contravenes the due process clause of the Fourteenth Amendment to the United States Consittution. *Welch* v. *Henry,* 305 U.S. 134 (1938). Accord *Commonwealth* v. *Budd Company,* 379 Pa. 159, 108 A.2d 563 (1954). Appellant so argued before the Pennsylvania Courts. The enactment of the 1978 Amendment retroactively attempting to reach tax year 1972 in order

The United States Supreme Court always examines the practical operation, application and enforcement of a state's tax statute, in appeals questioning the constitutionality of a state's construing, enforcing or applying the tax statute. In *American Oil Company* v. *Neill,* 380 U.S. 451 (1965), the Court ruled:

> "When passing on the constitutionality of a state taxing scheme it is firmly established that this court concerns itself with a practical operation of the tax, that is, substance rather than form. *State of Wisconsin* v. *J. C. Penney Co.,* 311 U.S. 435, 443-444; *Lawrence* v. *State Tax Commission,* 286 U.S. 276, 280, and cases cited therein. This approach requires us to determine the ultimate effect of the law as applied and enforced by a state or, in other words, to find the operating incidence of the tax. *Connecticut Gen. Life Ins. Co.* v. *Johnson,* 303 U.S. 77, 80."

The practical operation of the tax, and Appellee's application and enforcement of the manufacturing exemption, during its fiscal crisis, by a standard different than applied to all other taxpayers claiming the exemption, denied Appellant the equal protection of law guaranteed by the Fourteenth Amendment to the United States Constitution. This Court consistently declares state taxing statutes which deny equal protection of the law to be unconstitutional.

In *Southern Railway Co.* v. *Greene,* 216 U.S. 400 (1910), the court held that an Alabama Franchise Tax which applied only to foreign corporations, and not to domestic corporations, violated the equal protection

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to bar Appellant's claim admits the validity of Appellant's claim, and also demonstrates Appellee's discrimination against Appellant in violation of the equal protection clause. *Royster Guano, supra.*

clause of the Fourteenth Amendment. The Alabama Supreme Court and taxing officials advanced no explanation for treating foreign corporations differently than domestic corportions.

In *Colgate* v. *Harvey*, 296 U.S. 404, 423 (1935), an exemption from Vermont income tax for interest received on money loaned within Vermont was held invalid under the equal protection clause. The Court ruled that classification must rest upon some difference having a fair and substantial relation to the object of the legislation, applying the following test:

> "* * * does the statute arbitrarily and without genuine reason impose a burden upon one group of taxpayers from which it exempts another group, both of them occupying substantially the same relation toward the subject matter of the legislation? 'Mere difference is not enough * * *'"

In *Stewart Dry Goods Co.* v. *Lewis*, 294 U.S. 550 (1935), the Court held that the Kentucky adjusted gross sales tax could not be sustained as an excise on the privilege of merchandising, because no reasonable relation existed between the amount of the tax and the value of the privilege so as to justify discrimination between taxpayers.

In *Liggett Co.* v. *Lee*, 288 U.S. 517 (1933), a Florida statute which levied a heavier privilege tax per store on the owner whose stores were in different counties than on the owner whose stores were all in the same county was held by the Court to be arbitrary and void, because there was no "reasonable basis for this classification".

In *WHYY, Inc.* v. *Borough of Glassboro*, 393 U.S. 117 (1968), the Court held that the taxation of the real property of foreign nonprofit corporations by the State

of New Jersey while according an exemption to domestic nonprofit corporations denied the foreign nonprofit corporations equal protection of the laws in violation of the Fourteenth Amendment to the Constitution. As in *Colgate, Stewart* and *Liggett, supra*, the state courts and taxing officials in *WHYY* advanced no rational explanation to justify the inequality of treatment between taxpayers. In *Greene*, the court inferred arbitrary discrimination violating the equal protection clause from state tax officials' failure to advance any reason for the different treatment of the taxpayer. 253 U.S. at 415-416. Similarly, in the instant case, the Pennsylvania appellate courts advanced no explanation at all for their failing to adjudge Appellant's claim to the manufacturing exemption by the judicial definition uniformly used for more than 50 years to adjudge the claims of all other taxpayers seeking the exemption. Consequently, tested against *Greene* and its progeny, *supra*, the Pennsylvania appellate courts' construction and application of the manufacturing exemption under the Act, in Appellant's case, violate the equal protection clause. The Pennsylvania courts offered no explanation to justify their departing from the judicial definition of the term "manufacturing". Except for Appellee's fiscal crisis, no explanation exists!

Appellee's Discriminatory Enforcement of the Manufacturing Exemption Against Appellant Under an Otherwise Constitutional Statute Violates the Equal Protection Clause.

Under the equal protection clause, discriminatory administration and enforcement of an otherwise valid tax statute vitiates the statute. *Cumberland Coal Co.* v. *Board of Revision, Etc.*, 284 U.S. 23 (1931); *Sioux City Bridge Company* v. *Dakota County*, 260 U.S. 441 (1923); *Sunday Lake Iron Co.* v. *Wakefield*, 247 U.S. 350 (1918).

In *Sioux City, supra*, only taxpayer's bridge was assessed at full market value, and the property of all other taxpayers in the jurisdiction was assessed at substantially less than full value. The Nebraska Supreme Court held that the taxpayer's remedy was for the taxing authority to reassess the property of the other taxpayers at full value. The United States Supreme Court reversed, under the equal protection clause, holding:

> "This Court holds that the right of the taxpayer whose property alone is taxed at 100 percent of its true value is to have his assessment reduced to the percentage of that value at which others are taxed even though this is a departure from the requirement of statute. The conclusion is based on the principle that where it is impossible to secure both the standard of the true value, and the uniformity and equality required by law, the latter requirement is to be preferred as the just and ultimate purpose of the law. In substance and effect the decision of the Nebraska Supreme Court in this case upholds the violation of the Fourteenth Amendment to the injury of the Bridge Company. We must, therefore, reverse its judgment." 260 U.S. at 446-447.

Similarly, in *Sunday Lake Iron, supra*, the Court cautioned:

> "The purpose of the equal protection clause of the Fourteenth Amendment is to secure every person within the State's jurisdiction against intentional and arbitrary discrimination, whether occasioned by express terms of a statute or by its improper execution through duly constituted agents. And it must be regarded as settled that intentional systematic undervaluation by state officials of other taxable property in the same class contravenes the constitutional right of one taxed upon the full value of his property." 247 U.S. at 352-353.

Accord, *Cumberland Coal Co., supra*, wherein the Court followed *Sioux City* and *Sunday-Lake Iron*,

reversing the Supreme Court of Pennsylvania. In *Cumberland Coal Co.*, the Court held that the equal protection clause prevents taxing authorities from assesssing at uniform rate all coal in continuous vein, disregarding differences in actual or market value due to distances from transportation facilities and other factors. The taxing authorities' disregard of these differences in administering the tax constituted arbitrary discrimination repugnant to the equal protection clause. 284 U.S. at 28-30.

The equal protection clause requires that taxpayers, individual and corporate, bear the burdens of citizenship on a non-discriminatory basis. If Appellee's taxing officers and courts succeed, without any basis or explanation, in denying Appellant the manufacturing exemption by ignoring the time honored definition of the term "manufacturing" applied to all other taxpayers seeking the exemption, without overruling that definition, then the state tax liability of each taxpayer, individual or corporate, will hinge on the whim and fancy of every official vested with decision making power in state government. As a result, the equal protection clause will cease to safeguard taxpayers from the caprice or whim of the taxing power of state governments throughout the nation.

CONCLUSION

For the foregoing reasons, probable jurisdiction should be noted and the order of the Supreme Court of Pennsylvania must be reversed.

Respectfully submitted,

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APPENDIX

APPENDIX A

Order And Judgment Of The Supreme Court Of Pennsylvania

[J311]

IN THE SUPREME COURT OF PENNSYLVANIA
WESTERN DISTRICT

No. 80-1-92

THE POTOMAC EDISON COMPANY, *Appellant*,

v.

COMMONWEALTH OF PENNSYLVANIA, *Appellee*.

Appeal from the Final Order entered April 10, 1980 of the Commonwealth Court of Pennsylvania at No. 1315 C.D. 1975 Argued September 24, 1980

ORDER

PER CURIAM:

Filed: November 3, 1980

Order of Commonwealth Court is affirmed.

SUPREME COURT OF PENNSYLVANIA
WESTERN DISTRICT

No. 80-1-92

THE POTOMAC EDISON COMPANY, *Appellant*,

v.

COMMONWEALTH OF PENNSYLVANIA, *Appellee*.

JUDGMENT

ON CONSIDERATION WHEREOF, it is now here ordered and adjudged by this Court that the judgment of the COMMONWEALTH COURT OF PENNSYLVANIA, be, and the same is hereby Affirmed.

BY THE COURT:

CARL RICE, ESQUIRE
Prothonotary

Dated: November 3, 1980

APPENDIX B

Order Of Pennsylvania Supreme Court On Appellant's Application For Reargument

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"December 18, 1980

Denied.

Per Curiam"

APPENDIX C

Opinion And Final Order Of The Commonwealth Court Of Pennsylvania

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

No. 1315 C.D. 1975

THE POTOMAC EDISON COMPANY, *Appellant*,

v.

COMMONWEALTH OF PENNSYLVANIA, *Appellee*.

BEFORE: HONORABLE JAMES S. BOWMAN, *President Judge*
HONORABLE JAMES C. CRUMLISH, JR., *Judge*
HONORABLE GLENN E. MENCER, *Judge*
HONORABLE THEODORE O. ROGERS, *Judge*
HONORABLE DAVID W. CRAIG, *Judge*

ARGUED: November 14, 1979

OPINION BY JUDGE CRAIG

FILED March 10, 1980

The Potomac Edison Company (taxpayer) appeals from the order of the Board of Finance and Revenue sustaining the Department of Revenue's settlement of its 1972 franchise tax, in the amount of $65,363.10 with interest. The Department of the Auditor General approved the settlement, and taxpayer filed a petition for resettlement with the Department of Revenue and the Department of the Auditor General, which was refused. Taxpayer appeals.

Taxpayer is a Maryland corporation operating as a public utility, with a certificate of public convenience from the Pennsylvania Public Utility Commission. Taxpayer is a tenant-in-common, with West Penn Power Company and

PREVIOUS PAGE WAS BLANK

Monongahela Power Company, of a site known as Hatfield's Ferry Power Station (station), where those tenants operate a steam-driven electric power plant as a joint venture. Taxpayer owns an undivided 20% interest in the power plant and the underlying real property. From its share of the output of the station, taxpayer furnishes electric service only to customers in Maryland.

Section 602(b) of the Tax Reform Code of 1971, Act of March 4, 1971, P.L. 6, *as amended*, 72 P.S. §7602(b), imposes a franchise tax on every foreign corporation, joint-stock association and limited partnership, but provides:

> "That the manufacturing, processing, research and development exemptions as contained under section 602(a) [imposing a tax on the capital stock of domestic corporations] shall also apply to foreign corporations. . . ."[1]

Section 602(a), 72 P.S. §7602(a) states that:

> "Provided, That the provisions of this section shall not apply to the taxation of the capital stock of corporations, . . . organized for manufacturing, processing, research or development purposes. . . ."

Section 4 of the Act of July 1, 1978, P.L. 594, eliminated the manufacturing exemption as to those companies that "enjoy and exercise the right of eminent domain." The intent

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[1] The Act of March 4, 1971, P.L. 6 eliminated the manufacturing exemption for capital stock and franchise tax purposes, retroactive to January 1, 1971. By the Act of August 31, 1971, P.L. 362, the General Assembly again adopted a "manufacturing, processing, research and development" exemption, effective June 30, 1971 [*sic*; the exemption was restored effective July 1, 1972]. The disqualification for those otherwise exempt manufacturing, processing or research companies who "enjoy or exercise" the right of eminent domain did not appear in the tax legislation until by Act of July 1, 1978, P.L. 594, the eminent domain disqualfication was reenacted.

of the General Assembly, as stated in Section 3 of that act, was that this ineligibility for the manufacturing exemption be retroactive to August 31, 1971, or the "furthest legal date possible," if the retroactive effect to the stated date was determined to be unlawful.

Taxpayer contends that the production of electrical energy constitutes "manufacturing" for the purposes of Section 602(b), and that it is entitled to the exemption for the calendar year 1972.

The Commonwealth submits that taxpayer is not involved in "manufacturing" as that term has been defined by the case law, and alternatively contends that the intent of the legislature was not to include electric generating companies in the class of companies otherwise entitled to manufacturing exemptions.[2]

The applicability of the manufacturing exemption of the Tax Reform Code of 1971 to a corporation engaged in the production of electricity has not previously been directly before this court. Taxpayer relies upon precedents which this court, in *Golden Triangle Broadcasting, Inc.* v. *City of Pittsburgh*, 31 Pa. Commonwealth Ct. 547, 558, 377 A.2d 839, 845 (1977), characterized as "somewhat old and vague authority for the proposition . . . that the production of electricity, which could be considered an intangible, is 'manufacturing'." Specifically taxpayer relies on *Southern Electric Light and Power Co.* v. *Philadelphia*, 191 Pa. 170, 43 A. 123 (1899), and *Commonwealth* v. *Northern Electric Light and Power Co.*, 145 Pa. 105, 22 A. 839 (1891).

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[2] The Commonwealth also submits that if this court determines that taxpayer is involved in manufacturing, taxpayer would nonetheless be disqualified from the exemption under Section 2 of the Act of July 1, 1978, P.L. 594, amending Section 7602(a) and (b) of the Tax Reform Code of 1971, because it is a company that enjoys and exercises the right of eminent domain, as noted above.

In *Northern Electric, supra*, the Supreme court had to determine whether a company which produces electricity was a manufacturing company within the meaning of the Act of June 30, 1885, P.L. 193, which placed a tax on the capital stock of domestic corporations while exempting manufacturing companies from such taxation. The controlling question in the case was the sense in which the term "manufacturing companies" was used under the statute. The court specifically stated that it would not decide the question of whether the production of electricity was manufacturing, although the lower court had determined that it was not. The court held that Northern Electric was not entitled to exemption from the capital stock tax and based its holding on the definition of "manufacturing companies" as found in the general incorporation act, Act of April 29, 1874, P.L. 73, which provided for classes of manufacturing corporations, none of which included corporations engaged in providing a service of a quasi-public nature. The Supreme Court said:

> "Such companies have never been included in any of the legislation provided for the encouragement and protection of manufacturing corporations, and have no right to share in the benefits of such legislation. They really form a class by themselves." *Northern Electric and Power Co., supra*, 145 Pa. at 120, 22 A. at 841.

Although the court also stated that, "if this case depended on the question on which it turned in the court below, we should be led by the findings of fact to a different conclusion of law from that which was there reached, and hold that this company was a manufacturing company" 145 Pa. at 118, 22 A.2d at 840, that statement as to the meaning of manufacturing as a function was dictum because the court's actual holding was limited to the definition of "manufacturing companies."

In *Southern Electric Light and Power Co., supra*, the Supreme Court held that, although land parcels were held in reserve for future use, they were nevertheless part of the

premises exempt from local real estate tax. The brief per curiam opinion disclaims any distinction between the "manufacturing" of electricity and the "supplying" of it. The court was emphasizing the unity of the generating and distribution aspects, and whether Southern Electric's business actually constituted "manufacturing" was not before the court.

Thus, we do not believe that the above-cited cases have conclusively determined whether, for purposes of the Tax Reform Code of 1971, electric power companies are entitled to the manufacturing exemption.

We now hold, after a careful review of the applicable law, the parties' stipulations and the testimony at the evidentiary hearing, that an electric company is not entitled to the manufacturing exemption because the production of electricity is not manufacturing.

In considering whether the activities involved in the production and distribution of electricity constitute "manufacturing", the difficulty is the absence of a statutory definition of that term for the present context.[3] "Whether a particular activity is 'manufacturing' as that term has been defined by *case law only* is purely an issue of law under the facts of a particular case." *Golden Triangle Broadcasting, Inc.*, *supra*, 31 Pa. Commonwealth Ct. at 551-52, 377 A.2d at 842. (Emphasis in original.)

Of course, a modern generating plant is a technologically complex and sophisticated operation requiring expertise, labor and great expense.

At the evidentiary hearing, Dr. Howard Hamilton, a professor of electric power engineering at the University of Pittsburgh, testified extensively for the taxpayer on the

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[3] Section 602(c), 72 P.S. §7602(c), defines 14 operations that constitute "processing" for purposes of the processing exemption in Section 602(b).

production of electricity. He stated his opinion that useful electrical energy is a man-made product. He outlined the process by stating:

> "A. [W]e are taking raw materials, coal oxygen, in the form of air, water, and performing a series of processes with these ingredients, and the ultimate output is electrical energy or electricity as you mentioned."
>
> "Q. Describe this process.
>
> "A. Well, coal itself has an inherent energy. . . . The energy that is in this, or in the fuel here, in the coal, is energy in chemical form, and first in the process of producing electricity *the energy and the fuel is converted to heat*, and *the heat energy so produced is then carried along by water or steam*, in other words, we heat the water, the water is changed to vapor form, and *this acts as a carrier for the heat energy*; *the heat energy and the vapor or steam enters the steam turbine*, the *steam turbine converts the heat energy into mechanical energy*, the *shaft of the steam turbine then transmits the mechanical energy into the generator*, and the *generator's purpose is to convert the mechanical energy into electrical energy*, thus we have the complete cycle.
>
> "There are a lot of other activities associated with these multiple conversion processes that I haven't mentioned, for example, when you are circulating water, we are chemically treating the water to maintain purity, a great many aspects of the whole operation that are peripheral to but necessary in this energy conversion process.
>
> "*Essentially we are starting with chemical energy and going through the processes and finally coming out with electrical energy.*" (Emphasis supplied.)

Reviewing the judicial interpretation of the term "manufacturing" in *Commonwealth* v. *Deitch Co.*, 449 Pa.

88, 93, 295 A.2d 834, 837 (1972), our Supreme Court quoted with approval from *Commonwealth* v. *Berlo Vending Co.*, 415 Pa. 101, 104, 202 A.2d 94, 96 (1964):

> "'The meaning of "manufacturing" has been restated by this Court in *Philadelphia School District* v. *Parent Metal Products, Inc.*, 402 Pa. 361, 364, 167 A.2d 257, 258-59 (1961); "'Manufacturing' as used in a legislative enactment is given its ordinary and general meaning. It consists in the application of labor or skill to material whereby the original article is changed into a new, different and useful article: *Commonwealth* v. *Weiland Packing Company*, 292 Pa. 447, 449, 141 Atl. 148 (1928); *Pittsburgh* v. *Electric Welding Company*, 394 Pa. 60, 145 A.2d 528 (1958). . . ."
>
> "'On the same day as the decision in Parent Metal Products Co., we also decided *Philadelphia School District* v. *Rosenberg*, 402 Pa. 365, 368, 167 A.2d 259-60 (1961), in which we emphasized that "it is the popular or practical understanding of what is 'manufacturing' that prevails and is intended."'
>
> "Concededly, 'it is sometimes difficult to determine with legal exactness what is and what is not manufacturing', *Commonwealth* v. *McGrady-Rodgers Co.*, 316 Pa. 155, 158, 174 A. 395 (1934), for as one court has observed, '[i]t is easier to feel the line of distinction than to express it. . . .' *Philadelphia School District* v. *Mutual Trimming Co.*, 14 Pa. D.&C. 2d 207, 209 (1957)."

Thus, the touchstone of the legal concept of the term "manufacturing" is the application of skill and labor to original "material" whereby it is substantially changed into a new, different and useful "article". The traditional legal concept assumes tangible "material" as a starting point, and a continuity of existence of that material into the final product.

We therefore find crucial to our determination the fact, as the parties' stipulation and the testimony of taxpayer's expert witness point out, that the original material here, coal, is not material which survives in the new "product"; coal is simply the chemical energy source from which the entire process of electric generation begins, and in the process it is consumed and discarded. The harnessing of heat energy from the coal fuel, its conversion into mechanical energy in the turbine and the final conversion to electrical energy in the form of an electric current, is hence not "manufacturing" in the ordinary understanding of that term. Where no molecules of the original raw material survive in the final product, we thus do not have manufacturing in the judicial sense of "application of labor or skill" to "material."

We recognize that, in this electronic age, it may be scientifically myopic to recognize only continuity of tangible material and to ignore the equally real — although less tangible — continuity of elemental energy. However, we are construing legislation and therefore believe that the legislature intended to use the ordinary (and perhaps more easily applied) concept of tangible material. Until the legislature expressly indicates an intent to embrace more scientific concepts, we must assume adherence to "the popular and practical understanding," as the Supreme Court said in *Deitch*, *supra* and *Berlo Vending*, *supra*.

Having determined that taxpayer is not entitled to the manufacturing exemption of the franchise tax, we need not consider the eminent domain disqualification issue, but may proceed to enter judgment in favor of the Commonwealth and against taxpayer in the amounts stipulated to by the parties in their Stipulation of Facts I (dated May 4, 1979): $97,755.00 of which $65,363.10 has been paid by taxpayer. The remainder shall be paid with interest, as provided by law.

David W. Craig, Judge
DAVID W. CRAIG

President Judge Bowman did not participate in the decision in this case. Judge DiSalle did not participate in the decision in this case.

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

No. 1315 C.D. 1975

THE POTOMAC EDISON COMPANY, *Appellant*,

v.

COMMONWEALTH OF PENNSYLVANIA, *Appellee*.

ORDER

AND NOW, this 10th day of March, 1980, unless exceptions are filed within thirty days of the date hereof, the Order of the Board of Finance and Revenue is affirmed. Judgment is entered in favor of the Commonwealth of Pennsylvania, and against Potomac Edison Co., with interest, in the amount stipulated by the parties in their Stipulation of Facts I, dated May 4, 1979 ($97,755.00 of which $65,363.10 has already been paid).

/s/ DAVID W. CRAIG
David W. Craig, *Judge*

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

No. 1315 C.D. 1975

THE POTOMAC EDISON COMPANY, *Appellant*,

v.

COMMONWEALTH OF PENNSYLVANIA, *Appellee*.

FINAL ORDER

AND NOW, this 10th day of April 1980, the Exceptions of Appellant, The Potomac Edison Company, are overruled. The Order of the Board of Finance and Revenue is affirmed, and the appeal of The Potomac Edison Company from the Order is dismissed and denied. Judgment is directed to be entered in favor of the Commonwealth of Pennsylvania and against The Potomac Edison Company, with interest, in the amount stipulated by the parties in their Stipulation of Facts I, dated May 4, 1979 ($97,755.00 of which $65,363.10 has already been paid).

BY THE COURT

/s/ GLENN E. MENCER, *Judge*

APPENDIX D

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

No. 1315 Commonwealth Docket 1975

THE POTOMAC EDISON COMPANY, *Appellant*,

v.

COMMONWEALTH OF PENNSYLVANIA, *Appellee*.

Notice of Appeal To The Supreme Court Of The United States

Notice is hereby given that The Potomac Edison Company, the Appellant, hereby appeals to the Supreme Court of the United States from the *per curiam* order and the judgment of the Supreme Court of Pennsylvania, entered November 3, 1980, application for reargument denied *per curiam* December 18, 1980, upholding the disallowance of Appellant's claim to the manufacturing exemption from 1972 Pennsylvania Franchise Tax and the validity of Article VI of the Tax Reform Code of 1971, Act of March 4, 1971, P.L. 88-92 §§601 *et seq.*, as amended, 72 P.S. §§7601 *et seq.*, as amended, as applied to Appellant.

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This appeal is taken pursuant to the United States Code Title 28 Section 1257(2).

Respectfully submitted,

/s/ LLOYD R. PERSUN
Lloyd R. Persun

/s/ HOWELL C. METTE
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Attorneys for Appellant

Filed: January 22, 1981

IN THE SUPREME COURT OF PENNSYLVANIA

No. 80-1-92

THE POTOMAC EDISON COMPANY, *Appellant*,

v.

COMMONWEALTH OF PENNSYLVANIA, *Appellee*.

Notice of Appeal to the Supreme Court of the United States

Notice is hereby given that The Potomac Edison Company, the Appellant, hereby appeals to the Supreme Court of the United States from the *per curiam* order and the judgment of the Supreme Court of Pennsylvania, entered November 3, 1980, application for reargument denied *per curiam* December 18, 1980, upholding the disallowance of Appellant's claim to the manufacturing exemption from 1972 Pennsylvania Franchise Tax and the validity of Article VI of the Tax Reform Code of 1971, Act of March 4, 1971, P.L. 88-92 §§601 *et seq.*, as amended, 72 P.S. §§7601 *et seq.*, as amended, as applied to Appellant.

This appeal is taken pursuant to the United States Code Title 28 Section 1257(2).

Respectfully submitted,

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Filed: January 26, 1981

APPENDIX E

Relevant Portions Of Article VI Of The Pennsylvania Tax Reform Code Of 1971, As Amended

(Act of August 31, 1971, P.L. 389-390)

ARTICLE VI
CAPITAL STOCK-FRANCHISE TAX

* * *

PART II
IMPOSITION OF TAX

Section 602 Imposition of Tax.

(a) ***Provided, That the provisions of this section shall not apply to the taxation of the capital stock of corporations, limited partnerships and joint-stock associations organized for manufacturing, processing, research or development purposes, which is invested in and actually and exclusively employed in carrying on manufacturing, processing, research or development within the State, but every corporation, limited partnership or joint-stock association organized for the purpose of manufacturing, processing, research or development shall pay the State tax of ten mills herein provided, upon such proportion of its capital stock, if any, as may be invested in any property or business not strictly incident or appurtenant to the manufacturing, processing, research or development business, in addition to the local taxes assessed upon its property in the district where located, it being the object of this proviso to relieve from State taxation only so much of the capital stock as is invested purely in the manufacturing, processing, research or development plant and business.

and pay into the treasury of the Commonwealth annually, through the Department of Revenue, a franchise tax at the rate of ten mills for the calendar year 1971 and the fiscal year beginning in 1971 and each year thereafter, upon a taxable value to be determined in the following manner. The actual value of its whole capital stock of all kinds, including common, special, and preferred, shall be ascertained in the manner prescribed in Section 601 of this article. The taxable value shall then be determined by employing the relevant apportionment factors set forth in Article IV: Provided, That the manufacturing, processing, research and development exemptions as contained under section 602(a) shall also apply to foreign corporations and in determining the relevant apportionment factors the numerator and the property, payroll, or sales factors shall not include any property payroll or sales attributable to manufacturing, processing, research or development activities in the Commonwealth.

APPENDIX F

Listing Of Cases

Commonwealth v. *Boyer Plumbing & Heating Co.*, 49 C.C. 610, 30 D. 275 (1920)

Commonwealth v. *Weiland Packing Co.*, 292 Pa. 447, 141 A.246 (1928)

Commonwealth v. *Paul W. Pounds Co.*, 316 Pa. 29, 173 A.633 (1934)

Commonwealth v. *McCrady-Rodgers Company*, 316 Pa. 155, 174 A.395 (1934)

Commonwealth v. *Trinity Court Studios*, 37 Dauphin 244 (1934)

Commonwealth v. *Harrisburg Gas Company*, 50 Dauphin 383 (1941)

Commonwealth v. *American Ice Co.*, 406 Pa. 322, 178 A.2d 491 (1962)

Commonwealth v. *Berlo Vending Company*, 415 Pa. 101, 202 A.2d 94 (1964)

Commonwealth v. *Tetley Tea Co., Inc.*, 421 Pa. 614, 220 A.2d 832 (1966)

Commonwealth v. *Rudd-Melikian, Inc.*, 86 Dauphin 275, 41 D & C 2d 425 (1966)

Commonwealth v. *Babcock Lumber Co*, 1 Pa. Commonwealth Ct. 32 271 A.2d 889 (1970)

Morrisville Scrap Processing Company, Inc. Tax Appeal, 6 Pa. Commonwealth Ct. 121, _____ A.2d _____ (1972) affirmed 453 Pa. 610, 307 A.2d 905 (1973)

Commonwealth v. *Deitch Co.*, 449 Pa. 88, 295 A.2d 834 (1972)

Commonwealth v. *Perfect Photo, Inc.*, 29 Pa. Commonwealth Ct., 316, 371 A.2d 580 (1977)

This listing of cases is not exhaustive. There are numerous other cases involving the manufacturing exemption not only from capital stock tax or franchise tax but also from various local taxes such as mercantile taxes and business privilege taxes, which apply the judicial definition of the term "manufacturing". E.g., *Philadelphia School District* v. *Parent Metal Products, Inc.*, 402 Pa. 361, 167 A.2d 257 (1961); *Pittsburgh Press Co.* v. *City of Pittsburgh*, 14 Pa. Commonwealth Ct. 551, 322 A.2d 290 (1974).

ALEXANDER L.
CLERK

No. 80-1303

In the Supreme Court of the United States

October Term, 1980

THE POTOMAC EDISON COMPANY,
Appellant,

v.

COMMONWEALTH OF PENNSYLVANIA,
Appellee.

On Appeal From the Supreme Court of Pennsylvania.

MOTION TO DISMISS OR AFFIRM

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TABLE OF CONTENTS

	PAGE
Questions Presented	1
Motion To Dismiss or Affirm	2
Statement of the Case	3
Summary of Argument	5
Argument:	
A. The Equal Protection Clause of the U. S. Constitution, Appellant's only grounds for presenting a federal question on appeal, is not violated by the decision of the Pennsylvania Supreme Court in the instant case	6
B. Even if this Court finds that a substantial federal question is raised by the appeal, it should still be dismissed because the Appellant has not properly preserved the federal question	17
C. The judgment here appealed from rests on an adequate non-federal basis	19
Conclusion	19
Appendix "A"—Exceptions to the Lower Court's Opinion	20

TABLE OF CITATIONS

CASES:

Commonwealth v. American Car and Foundry Co., 203 Pa. 302 (1902)	14, 15
Commonwealth v. Berlo Vending Company, 415 Pa. 101, 202 A.2d 94 (1964)	8

Commonwealth v. Deitch Co. 449 Pa. 88, 295 A.2d 834 (1972) 8, 9

Commonwealth v. Keystone Electric Light, Heat and Power Company, 193 Pa. 245 (1899) 13

Commonwealth v. The Edison Electric Light & Power Co. of Erie, 1 Dauph. 127 (1895) affirmed 170 Pa. 231 (1895) 13, 14

Commonwealth v. Northern Electric Light & Power Co., 145 Pa. 105 (1891) 5, 12, 13, 14

STATUTES:

Act of August 31, 1971, P.L. 362 15

Act of July 1, 1978, P.L. 594 ..... 7, 11

Tax Reform Code of 1971, Act of March 4, 1971, P.L. 88, No. 2, Art. VI, Section 601 et seq., 72 P.S. 7601 et seq. 6

OTHER AUTHORITY:

Rule 16 (a) and (b) of Rules of Supreme Court of United States 18, 19

QUESTIONS PRESENTED

When the courts of Pennsylvania determined that the Appellant was not entitled to exclude from the base of the Foreign Franchise Tax the value of assets used in generating electricity because of its failure to qualify for manufacturer's exemption contained therein, was the Equal Protection Clause of the United States Constitution violated so as to present in this appeal a substantial federal question?

If a substantial federal question is presented, has the Appellant properly preserved its right to appeal to the United States Supreme Court when the Appellant limited the constitutional violations raised in its exceptions to the Commonwealth Court's opinion to the question of whether or not the "right of eminent domain, its enjoyment and exercise were relevant or material to this case"?

Since the decision appealed from is adequately based on non-federal law, i.e., that for Pennsylvania corporate tax purposes the generation of electricity is not manufacturing, should not this appeal be dismissed or affirmed?

MOTION TO DISMISS OR AFFIRM

Appellee moves that the present appeal be dismissed or that the final judgment of the Supreme Court of Pennsylvania be affirmed on the grounds in the alternative that: (1) the appeal does not present a substantial federal question; (2) that the federal question submitted by the Appellant was not properly raised in Appellant's appeal to the Pennsylvania Supreme Court and not expressly passed on by that Court; or (3) the judgment entered by the Commonwealth Court of Pennsylvania and affirmed per curiam by the Pennsylvania Supreme Court rests on an adequate non-federal basis.

STATEMENT OF THE CASE

The Commonwealth accepts in part the facts as stated in Appellant's Jurisdictional Statement. Obviously, the Commonwealth does not accept the many conclusions of law contained therein. For example, Appellant's statements that his expert witness's testimony proved that the Appellant's activities constituted manufacturing for Pennsylvania tax purposes. The Commonwealth submits that the generation of electricity at the Appellant's plant in Pennsylvania is not manufacturing for Pennsylvania corporate tax purposes in accordance with the holding of the Commonwealth Court's opinion stated on page 9A of Appellant's Jurisdictional Statement, to wit:

> "We now hold, after a careful review of the applicable law, the parties stipulations and the testimony at the evidentiary hearing, that an electric company is not entitled to the manufacturing exemption because the production of electricity is not manufacturing."

This appeal can only be allowed if the decision by the Pennsylvania Supreme Court that activities of the Appellant do not constitute manufacturing as that term is used in Pennsylvania corporate taxation violated the Equal Protection Clause of the United States Constitution and, therefore, presents a substantial federal question.

Appellant's assertion that the Capital Stock Tax, which is the companion tax to the Foreign Franchise Tax here involved and which is applicable to the domestic corporations, is not involved in this appeal is without merit.

The same manufacturing exemption exists for both taxes, and a decision in a Foreign Franchise Tax case that a particular activity is manufacturing would necessarily affect the question of what is manufacturing for the other tax.

Alternatively, if a substantial federal question is presented, Appellant has not properly preserved it in that its exceptions limited its constitutional objections to the question of whether or not the Appellant enjoyed or exercised the power of eminent domain in Pennsylvania. Neither the Commonwealth Court nor the Pennsylvania Supreme Court determined or even considered this issue in reaching their decision.

SUMMARY OF ARGUMENT

Courts of Pennsylvania have consistently held since 1891 in the *Northern Electric case,* infra, that electric generating companies were not entitled to the manufacturer's exemption contained in Pennsylvania corporate taxes. The denial of the manufacturer's exemption to electric generating companies has been applied to all domestic and foreign electric generating companies without exception. Because the denial has been consistent and applied to both foreign and domestic companies, the Commonwealth submits that the Appellant's appeal in the instant case does not present a substantial federal question that should be reviewed by the United States Supreme Court.

An additional reason to dismiss or affirm Appellant's appeal in the instant case is that Appellant has not properly preserved its potential federal question in this matter. The Appellant limited the constitutional question of equal protection to the issue of "eminent domain." Since this issue was not germane to the holding in this case, the question of equal protection has not been properly preserved.

Additionally, the decision of the Pennsylvania Commonwealth Court sustained by the per curiam opinion of the Pennsylvania Supreme Court is adequately grounded on non-federal law.

ARGUMENT

A. The Equal Protection Clause of the U. S. Constitution, Appellant's only grounds for presenting a federal question on appeal, is not violated by the decision of the Pennsylvania Supreme Court in the instant case.

The Tax Reform Code of 1971, Act of March 4, 1971, P.L. 88, No. 2, Art. VI, Section 601 et seq., 72 P.S. 7601 et seq. pp., sets forth the provisions of the Capital Stock-Franchise Tax, and it provides in pertinent part:

"Article VI Capital Stock Tax-Franchise Tax

"Part 2. Imposition of tax

"(a) That every *domestic corporation* . . . shall be subject to, and pay . . . a tax . . . , upon each dollar of the actual value of its whole capital stock of all kinds, . . . Provided, That the provisions of this section shall not apply to the taxation of the capital stock of corporations, . . . organized for manufacturing, . . . which is invested in and actually and exclusively employed in carrying on manufacturing, . . .

"(b) Every *foreign corporation*, . . . shall be subject to and pay . . . , a franchise tax . . . upon a taxable value. . . Provided, That the manufacturing, . . . exemptions as contained under section 602(a) shall also apply to foreign corporations and in determining the relevant apportionment factors the numerator of the property, payroll, or sales factors shall not

include any property, payroll or sales attributable to manufacturing, . . . activities in the Commonwealth." (Emphasis supplied.)

The amendment of July 1, 1978, P.L. 594, added the following:

"The provisions of this article shall apply to the taxation of corporations, limited partnerships and joint-stock associations organized for manufacturing, processing, research or development purposes, but shall not apply to such companies as enjoy and exercise the right of eminent domain."

Both section (a) with respect to domestic corporations and section (b) dealing with foreign corporations exempt manufacturing activities from the tax imposed. Since the decision in this case treats foreign and domestic corporations substantially the same for purposes of Pennsylvania corporate taxation, there is no question of discrimination between foreign corporations and domestic corporations, hence no violation of the Equal Protection Clause found in the 14th Amendment to the United States Constitution on this ground. Appellant's contention that the denial to it of the manufacturing exemption by the Pennsylvania courts applying a different definition of "manufacturing" than has been uniformly applied for over 50 years to all other taxpayers claiming the exemption results in a violation of the Equal Protection Clause is spurious and without merit. The Commonwealth submits that the Pennsylvania courts have consistently applied the exemption as it has developed through a long series of court cases in a fair and equal manner.

The Foreign Franchise Tax, supra, is a privilege tax imposed by the Commonwealth on foreign corporations

which do business in Pennsylvania. The Capital Stock Tax is a property tax imposed upon domestic corporations engaged in business in the Commonwealth. Both of these acts exempt from the tax imposed therein assets used in manufacturing. This so-called "manufacturer's exemption" has been a part of the Pennsylvania law for many years.

The term "manufacturing" in the corporate tax acts has not been defined by statute necessitating the courts of Pennsylvania to define the term. See *Commonwealth v. Deitch Co.*, 449 Pa. 88, 295 A.2d 834 (1972), where the Pennsylvania Supreme Court said:

> "The element of difficulty in this and other cases dealing with the capital stock tax [or franchise tax] manufacturing exemption arises from the absence of any statutory definition of the term 'manufacturing.'
>
> "This definitional vacuum has been filled by a judicial definition of the term which has emerged from a long line of cases extending back over 100 years' time. . . ." *Commonwealth v. Deitch Co.*, 449 Pa. 88, 92, 295 A.2d 834 (1972).

In making its decision in the *Deitch* case, the Pennsylvania Supreme Court relied upon the definition of manufacturing set forth in *Commonwealth v. Berlo Vending Company*, 415 Pa. 101, 202 A.2d 94 (1964), and on page 93 of *Deitch* quoted that definition as follows:

> "'The meaning of "manufacturing" has been restated by this Court in Philadelphia School District v. Parent Metal Products, Inc., 402 Pa. 361, 364, 167 A.2d 257, 258-59 (1961), *"Manufacturing" as used in a legislative enactment is given its ordinary and*

general meaning. It consists in the application of labor or skill to material whereby the original article is changed into a new, different and useful article: Commonwealth v. Weiland Packing Company, 292 Pa. 447, 449, 141 Atl. 148 (1928); Pittsburgh v. Electric Welding Company, 394 Pa. 60, 145 A.2d 528 (1958). *Whether or not an article is a manufactured product depends upon whether or not it has gone through a substantial transformation in form, qualities and adaptability in use from the original material, so that a new article or creation has emerged:* General Foods Corp. v. Pittsburgh, 383 Pa. 244, 118 A.2d 572 (1955). If there is merely a superficial change in the original materials, without any substantial and well signalized transformation in form, qualities and adaptability in use, it is not a new article or new production: Commonwealth v. Weiland, supra; Pittsburgh v. Electric Welding Co., supra.'

'On the same day as the decision in Parent Metal Products Co., we also decided Philadelphia School District v. Rosenberg, 402 Pa. 365, 368, 167 A.2d 259-260 (1961), in which we emphasized that "it is the popular or practical understanding of what is 'manufacturing' that prevails and is intended." ' " (Emphasis supplied.)

The Commonwealth Court in its opinion found on page 11 (a) of Appellant's Jurisdictional Statement, quoted the above decisional definitions of the term and concluded thusly:

"Thus, the touchstone of the legal concept of the term 'manufacturing' is the application of skill and labor to original 'material' whereby it is substantially changed into a new, different and useful 'article'.

The traditional legal concept assumes tangible 'material' as a starting point, and a continuity of existence of that material into the final product.

"We therefore find crucial to our determination the fact, as the parties' stipulation and the testimony of taxpayer's expert witness point out, that the original material here, coal, is not material which survives in the new 'product'; coal is simply the chemical energy source from which the entire process of electric generation begins, and in the process it is consumed and discarded. The harnessing of heat energy from the coal fuel, its conversion into mechanical energy in the turbine and the final conversion to electrical energy in the form of an electric current, is hence not 'manufacturing' in the ordinary understanding of that term. Where no molecules of the original raw material survive in the final product, we thus do not have manufacturing in the judicial sense of 'application of labor or skill' to 'material'.

"We recognize that, in this electronic age, it may be scientifically myopic to recognize only continuity of tangible material and to ignore the equally real—although less tangible—continuity of elemental energy. However, we are construing legislation and therefore believe that the legislature intended to use the ordinary (and perhaps more easily applied) concept of tangible material. Until the legislature expressly indicates an intent to embrace more scientific concepts, we must assume adherence to 'the popular and practical understanding,' as the Supreme Court said in Deitch, supra and Berlo Vending, supra."

The basic premise of the Court's opinion was that no new product was created by the generation of electricity.

Energy which was inherent in the raw material used to produce the steam, i.e. coal, was unlocked and through a chemical and physical change this heat energy was converted into electrical energy; however, no new product was created. The Appellant started with energy and ended with energy in a different form; hence, there was no manufactured product as the term has been defined by the courts of Pennsylvania.

The Commonwealth submits that, since the definition of manufacturing is a court determined definition, equal protection is not violated unless the Appellant could show that the Pennsylvania courts vary the definition as it applied to foreign and domestic corporations to favor one over the other. All corporations generating electricity in Pennsylvania have been treated the same, i.e., the manufacturing exemption has been denied, hence, there can be no violation of equal protection.

Appellant's assertion that the Pennsylvania courts held that generating electricity was not manufacturing because of the adverse fiscal impact on Commonwealth's revenues by an opposite holding is without foundation. The court's decision is amply based on a comprehensive review of the decisional definition of manufacturing. Appellant's claim that the Act of July 1, 1978, P.L. 594, specifically denying the exemption to "companies as enjoy or exercise the right of eminent domain" aids its cause is without merit. The purpose of the amendment was obviously to limit the fiscal impact on the state, certainly a valid legislative purpose. However, the recognition by the Legislature that an adverse decision by the court in Appellant's case does not in any way indicate that the court's ultimate decision that a generator is not entitled to the manufacturer's exemption was based on fiscal impact.

The fact that the legislation takes away the potential claim by generators of electricity retroactive to the furthest constitutional date by its very terms cannot violate any constitutional protection that taxpayers enjoy with respect to retroactive legislation. The legislation itself limited the retroactive feature to the furthest constitutional date without specifying what that date would be. Since our court held that generators were not entitled to the manufacturer's exemption, there was no need for the court to decide what the furthest retroactive taxation could be. Obviously, a statute which by its very terms refers to the Constitution and limits its effect to whatever is constitutional, cannot be unconstitutional. Further, the Courts of Pennsylvania did not in their opinion rely on this provision because they decided that the taxpayer was not entitled to the exemption on other grounds, i.e., that generating electricity is not manufacturing. Hence, appellant's contention that a substantial federal question is presented by this appeal is without merit.

The denial of the exemption to electric generating companies under Pennsylvania law has been uniform since at least 1891 when in the case of *Commonwealth v. Northern Electric Light & Power Co.*, 145 Pa. 105 (1891), the Pennsylvania Supreme Court concluded that under a previous Capital Stock Tax Act electric generating corporations were not entitled to the manufacturing exemption. Appellant's argument that equal protection is here violated because the courts of Pennsylvania have not applied the manufacturing exemption to it in the same manner that it was applied to other taxpayers over the past 50 years is wrong. The Commonwealth submits that the courts of Pennsylvania have been consistent in their application in all instances.

In *Commonwealth v. Keystone Electric Light, Heat and Power Company,* 193 Pa. 245, 251 (1899), the Pennsylvania Supreme Court stated that the holding of the *Northern Electric* case was as follows:

> ". . . Electric light, heat and power companies are manufacturing corporations within the meaning of the act of 1874 and its supplements. They are not exempt from a tax on their capital stock under section 20 of the act of 1885, because they are not *within the policy of the legislature* in passing that act, and it was not intended that they should share in its benefits. . . ." (Emphasis supplied.)

Parenthetically, it must be noted that this legislative policy has never wavered or been changed for over three quarters of a century.

The first time that a court was asked to construe the manufacturing exemption, contained in the Act of 1889, a successor Capital Stock Tax Act as it relates to electric generating corporations, was in the case of *Commonwealth v. The Edison Electric Light & Power Co. of Erie,* 1 Dauph. 127 (1895). In discussing its decision, the Court of Common Pleas of Dauphin County stated at page 128 as follows:

> "Neither, as already stated, is there any material difference between the exempting clause of the Act of 1885 and the similar clause in the Acts of 1889 and 1891. Whatever difference may exist makes against the defendant; for, as is well known to all who are familiar with legislative and judicial controversy over these clauses, the language of the later acts is intentionally more restricted than the language of the earlier act that was ineffectively invoked by the Northern Electric Co."

The court stated its conclusion on page 182 as follows:

> ". . . If the unqualified language of the Act of 1885, namely: 'manufacturing corporations' did not include a corporation such as the defendant, [an electric generating company], we do not think any fair process of construction can read it into the narrower phrase used by the Acts of 1889 and 1891, namely: 'corporations, limited partnerships and joint stock associations organized exclusively for manufacturing purposes and actually carrying on manufacturing within the state. . . ."

The Act of 1891, referred to in the two quotations above, related to an amendment to the Act of 1889 which made no change in the exemption provision with which we are herein concerned. This case was appealed to the Pennsylvania Supreme Court and was affirmed, per curiam, at 170 Pa. 231 (1895). It is significant that the manufacturing exemption was denied to an electric generating corporation under the Act of 1889 without the courts' opinions making any reference to the corporation's possessing the right of eminent domain, or the Act's prohibiting the exemption to corporations possessing the right. In other words, eminent domain was not a factor in the courts' decision.

The line of cases cited above laid to rest the question of whether electric generating corporations were entitled to the manufacturing exemption under the Act of 1889 and its many amendments. Even though it was not the direct question at issue, in *Commonwealth v. American Car and Foundry Co.*, 203 Pa. 302 (1902), the *Northern Electric* holding was again commented upon favorably. In reaching its conclusion that the Act of 1889 does not show

that the General Assembly did not include foreign corporations within the class of corporations entitled to the manufacturing exemption, at page 305 the Dauphin County Court stated:

> "If the question in this case were whether an electric light, heat and power company were exempt from the tax on capital stock we would, of course, unhesitatingly follow the precedent of the Northern Electric Light case and decide it was not. But the electric light cases are not authority for cases involving the question of the right of other companies to the exemption."

Thereafter, it was accepted by the taxpayers of the Commonwealth that electric generating corporations were not entitled to the manufacturing exemption as a matter of the public policy of the General Assembly, and the manufacturing exemption was never intentionally granted to an electric generating corporation by the taxing officials of the Commonwealth.

The pertinent portions of the Act of August 31, 1971, P.L. 362, do not differ in any material respect from the manufacturing exemption provision included in the Act of 1889 or from the provisions reintroducing the exemption in the Act of 1943. Nowhere in the Act of August 31, 1971 or in any other official publication of the General Assembly is there any indication that it was the intention of the General Assembly to change the public policy concerning the applicability of the manufacturing exemption to electric generating corporations.

Since all electric generating companies, both foreign and domestic, have consistently been denied the manufacturing exemption in Pennsylvania, there has not been

any discrimination so as to violate the Equal Protection Clause.

It is clear that under the Equal Protection Clause of the Federal Constitution, all that is required is uniformity of tax burden upon the person or corporation upon which the tax is assessed; in other words, there is nothing which prevents classification which is based upon well founded reason, if those within the class share its equal tax burden. The Constitution exacts, not uniformity of taxing laws, but uniformity of tax. Since all generators, both domestic corporations and foreign corporations, of electricity are denied the manufacturing exemption, there has been no violation of equal protection in this instance; hence, no federal question is presented by this appeal.

The Commonwealth submits that the denial of the manufacturing exemption to the generators of electricity does not violate the Equal Protection Clause of the 14th Amendment to the United States Constitution because the exemption is denied to all companies generating electricity, both domestic and foreign, and the application of this exemption by the courts of Pennsylvania has been consistently followed for many years.

It is clear that since Pennsylvania has chosen not to exempt any generator of electricity from tax, there can be no denial of equal protection.

B. Even if this Court finds that a substantial federal question is raised by the appeal, it should still be dismissed because the Appellant has not properly preserved the federal question.

The taxpayer did raise in its appeal and specification of objections, as pointed out in its brief, the federal constitutional protections that it is claiming were violated in this appeal. The Appellant did not brief or argue these questions before the lower court. Further, its exceptions to the lower court's opinion, attached as "Appendix A" to this brief, did not properly preserve this issue. The exceptions only referred to the Equal Protection Clause in one paragraph and limited that reference to the "eminent domain issue" which was not considered by the Pennsylvania courts. Appellant's Exception No. 11 reads as follows:

> "Assuming arguendo that the right of eminent domain, its enjoyment and exercise, *are relevant or material to this case,* Taxpayer excepts to your Honorable Court's refusal to rule that, as a matter of law, the General Assembly's attempt to make retroactive to calendar year 1972 the provisions of section 2 of the Act of July 1, 1978, P.L. 594, relating to amendments to subsections (a) and (b) of section 602 of the Tax Reform Code of 1971, is a denial of due process, violating the due process clauses of the Fourteenth Amendment to the United States Constitution and of Article I, sections 9 and 10 of the Pennsylvania Constitution, and also violates the uniformity clause of the Pennsylvania Constitution, Article 8, section 1 and the equal protection clause of the Four-

teenth Amendment to the United States Constitution." (Emphasis supplied.)

The Equal Protection Clause objection was raised only in connection with the eminent domain argument that was never reached by the Pennsylvania courts which held Appellant was not entitled to the manufacturing exemption because generating electricity is not manufacturing and not because the Appellant possessed or enjoyed the power of eminent domain.

The Commonwealth submits that the Pennsylvania Supreme Court could not have considered the equal protection argument raised by the Appellant in this appeal because it was not preserved by appropriate exceptions. Since the Pennsylvania Supreme Court could not properly consider this question, the Commonwealth submits that this Court cannot consider it because of Rule 16 (a) and (b) of the Rules of the Supreme Court of the United States which provide:

> "(a) The Court will receive a motion to dismiss an appeal on the ground that the appeal is not within this Court's jurisdiction, or because not taken in conformity with statute or *with these Rules.*
>
> "(b) The Court will receive a motion to dismiss an appeal from a state court on the ground that it does not present a substantial federal question; *or that the federal question sought to be reviewed was not timely or properly raised and was not expressly passed on;* or that the judgment rests on an adequate non-federal basis." (Emphasis supplied.)

In the instant case, the Pennsylvania Supreme Court could not have passed on this question unless it first determined that the question of "eminent domain" was germane

to the case. Neither the lower court nor the Pennsylvania Supreme Court ever reached this question because they held that generating electricity was not manufacturing without regard to the question of eminent domain.

C. The judgment here appealed from rests on an adequate non-federal basis.

The judgment entered by the Commonwealth Court, affirmed per curiam by the Pennsylvania Supreme Court, rests on the question of whether or not the generation of electricity is manufacturing within the meaning of that term in Pennsylvania corporate taxation. Since the decision is based on Pennsylvania court definitions uniformly applied to all taxpayers, both foreign and domestic, for almost 100 years, there is obviously a non-federal basis for the decision, and in accordance with Rule 16 (b), supra, of the Rules of the United States Supreme Court this appeal should be affirmed or dismissed.

CONCLUSION

For the foregoing reasons, the Commonwealth's Motion to Dismiss or Affirm should be granted.

Respectfully submitted,

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APPENDIX "A"

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

No. 1315 C.D. 1975

Commonwealth of Pennsylvania Board of Finance and Revenue,

Appellee

v.

The Potomac Edison Company,

Appellant

EXCEPTIONS OF APPELLANT

AND NOW, this 25th day of March, 1980, Appellant, The Potomac Edison Company (hereinafter "Taxpayer"), by its attorneys, Shearer, Mette & Woodside, excepts to your Honorable Court's Findings of Fact, Conclusions of Law, Opinion and Order and to the failure of your Honorable Court to hold in accordance with the positions advanced by Taxpayer in its Brief and oral argument, and specifies its exceptions as follows:

1. The Findings of Fact contained in paragraph 2 on page 1 of the Opinion are incomplete and therefore incorrect. Taxpayer is a Maryland corporation providing

electricity service to the public only in Maryland. Taxpayer provides no electricity service to the public in Pennsylvania. At all times material to this case, Taxpayer's only activity in Pennsylvania was its undivided 20% ownership as tenant in common in the coal-fired, steam-driven electric power plant at Hatfield's Ferry Power Station (hereinafter the "power plant"), its underlying real property and its electricity output. The other tenants in common with Taxpayer were Monongahela Power Company and West Penn Power Company. West Penn Power Company operated the power plant. At all times material to this case, Taxpayer had no service territory or customers in Pennsylvania. From its share of the power plant's output, Taxpayer furnished electric service to its customers in Maryland. (Partial Stipulation of Facts I ¶8, Ex. E; Tr. 46).

2. Taxpayer excepts to your Honorable Court's Finding of Fact contained in paragraph 11 on page 5 of its Opinion that "the production of electricity is not manufacturing." The uncontroverted testimony of Howard B. Hamilton, P.E. at trial established that electricity is manufactured at the power plant. (Tr. 8-9, 11, 14-16, 18).

3. Taxpayer excepts to your Honorable Court's Conclusion of Law (at pages 3-5 of the Opinion) that Pennsylvania case law has not determined, conclusively, that the production of electricity is manufacturing. This Conclusion of Law is contrary to case law decided not only by your Honorable Court but also by the Pennsylvania Supreme Court and the overwhelming majority of appellate courts in other states. In *Commonwealth of Pennsylvania v. Philadelphia Electric Company*, 21 Commonwealth Ct. 593, 347 A.2d 494 (1975), reversed on other grounds, 472 Pa. 530, 372 A.2d 815 (1977), your Honor-

able Court ruled that the production of electricity through steam generators, nuclear power plants, hydroelectric dams, diesel turbines, and pump storage projects constitutes manufacturing. In *Golden Triangle Broadcasting, Inc. v. City of Pittsburgh,* 31 Commonwealth Ct. 547, 558, 37 A.2d 839, 844, 845 (1977) your Honorable Court decided to "accept that *Southern Electric, supra* [191 Pa. 170 (1899)], and *Keystone Electric, supra* [193 Pa. 245 (1899)], hold that the production of electricity, which could be considered an intangible, is 'manufacturing'." See also, case law cited in Taxpayer's Brief, at 19-23, 31-36 and Appendix I.

4. Taxpayer excepts to your Honorable Court's holding, at page 5 of the Opinion, "that an electric company is not entitled to the manufacturing exemption because the production of electricity is not manufacturing." This holding contravenes the case law, the stipulated facts and the trial testimony.

5. Taxpayer excepts to your Honorable Court's Conclusion of Law in paragraph 16 on page 9 of the Opinion that "[w]here no molecules of the original raw material survive in the final product we thus do not have manufacturing in the judicial sense of 'application of labor or skill' to 'material'." The case law definition of the term "manufacturing" contains no requirement that molecules of the original raw material survive in the final product in order for a process to constitute "manufacturing".

6. Assuming *arguendo* that "molecules of the original raw material" are required to "survive in the final product" in order for a process to constitute "manufacturing", Taxpayer excepts to your Honorable Court's refusal to rule and to find as a fact that the production of electric-

ity at the power plant satisfied this requirement. Dr. Hamilton so testified at trial on direct and on cross-examination. (Tr. 13-14, 16-17, 22-23) His testimony is uncontroverted.

7. Taxpayer excepts to your Honorable Court's refusal to find as a fact that electricity is manufactured at the power plant and to your Honorable Court's refusal to hold as a matter of law that the manufacture of electricity at the power plant qualifies Taxpayer for the manufacturing exemption from franchise tax for the second six months of 1972.

8. Taxpayer excepts to your Honorable Court's refusal to grant Taxpayer the manufacturing exemption from franchise tax for the second six months of 1972.

9. Taxpayer excepts to your Honorable Court's refusal to rule that, as a matter of law, the right of eminent domain, its enjoyment and exercise, are not relevant or material to this case.

10. Assuming *arguendo* that the right of eminent domain, its enjoyment and exercise, are relevant or material to this case, Taxpayer excepts:

(a) to your Honorable Court's refusal to rule and to find as a fact that Taxpayer did not enjoy the right of eminent domain in Pennsylvania; and

(b) to your Honorable Court's refusal to rule and to find as a fact that Taxpayer did not exercise the right of eminent domain during 1972 in any jurisdiction.

11. Assuming *arguendo* that the right of eminent domain, its enjoyment and exercise, are relevant or material to this case, Taxpayer excepts to your Honorable

Court's refusal to rule that, as a matter of law, the General Assembly's attempt to make retroactive to calendar year 1972 the provisions of section 2 of the Act of July 1, 1978, P.L. 594, relating to amendments to subsections (a) and (b) of sections 602 of the Tax Reform Code of 1971, is a denial of due process, violating the due process clauses of the Fourteenth Amendment to the United States Constitution and of Article I, sections 9 and 10 of the Pennsylvania Constitution, and also violates the uniformity clause of the Pennsylvania Constitution, Article 8, section 1 and the equal protection clause of the Fourteenth Amendment to the United States Constitution.

12. Taxpayer excepts to your Honorable Court's failure to rule inadmissible at trial the testimony of John D. Grove and Commonwealth's Exhibit No. 1. That testimony and exhibit are irrelevant and immaterial at bar and lack foundation. Taxpayer excepts to your Honorable Court's failure to strike and to expunge that testimony and exhibit from the Record.

13. Your Honorable Court's Opinion and Order are against the law.

14. Your Honorable Court's Opinion and Order are against the stipulated facts and the trial testimony.

15. Taxpayer excepts to your Honorable Court's refusal to resettle Taxpayer's franchise tax liability to the Commonwealth of Pennsylvania at $48,877.50 (which already has been paid) and to your Honorable Court's failure to enter judgment in favor of Taxpayer and against the Commonwealth of Pennsylvania in the amount of $16,485.60 representing a refund or credit to Taxpayer of its overpayment of its 1972 franchise tax liability to the Commonwealth of Pennsylvania.

16. Taxpayer excepts to your Honorable Court's proceeding to enter judgment in favor of the Commonwealth of Pennsylvania and against Taxpayer as follows:

> "$97,755.00 of which $65,363.10 has been paid by Taxpayer. The remainder shall be paid with interest as provided by law."

17. Taxpayer excepts to your Honorable Court's entering the following Order:

> "AND NOW, this 10th day of March, 1980, unless exceptions are filed within 30 days of the date hereof, the Order of the Board of Finance and Revenue is affirmed. Judgment is entered in favor of the Commonwealth of Pennsylvania and against Potomac Edison Co., with interest, in the amount stipulated by the parties in their Stipulation of Facts I dated May 4, 1979 ($97,755.00 of which $65,363.10 has already been paid).
>
> /s/ David W. Craig
> David W. Craig, Judge"

Respectfully submitted,

(s) Lloyd R. Persun
Lloyd R. Persun

(s) Howell C. Mette
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The Potomac Edison Company

March 25, 1980

PROOF OF SERVICE

I hereby certify that I am this day serving a copy of the foregoing Exceptions upon the following person and in the manner indicated below, which service satisfied the requirements of Pa. R.A.P. 121 and 2187:

Service by first class mail addressed as follows:

Eugene J. Anastasio, Esquire, Deputy Attorney General, Department of Justice, Tax Litigation Unit, Strawberry Square—15th Floor, Harrisburg, Pennsylvania 17120

Lloyd R. Persun
Lloyd R. Persun
Attorney for Appellant,
The Potomac Edison Company

Dated: March 25, 1980

No. 80-1303

APR 7 198

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

THE POTOMAC EDISON COMPANY, *Appellant,*

v.

THE COMMONWEALTH OF PENNSYLVANIA, *Appellee.*

On Appeal From The Supreme Court Of Pennsylvania

APPELLANT'S BRIEF OPPOSING MOTION TO DISMISS OR AFFIRM

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TABLE OF CONTENTS

	PAGE
ARGUMENT	1
The Equal Protection Argument, Which Is A Substantial Federal Question, Is Properly Before The Supreme Court Of The United States	1
Pennsylvania Courts Have Not Followed The Definition Which Was Used To Deny Appellant's Claim To The Manufacturing Exemption	6
CONCLUSION	7

TABLE OF AUTHORITIES

CASES:	PAGE
Cumberland Coal Co. v. *Board of Revision, Etc.*, 284 U.S. 23, 24-25 (1931)	2, 5
Great Northern Railway Co. v. *Sunburst Oil & Refining Co.*, 287 U.S. 358, 363, 366-367 (1932)	2, 4, 5
Kirks Milk Products, Inc. v. *Commonwealth of Pennsylvania*, No. 1443 Commonwealth Docket 1976, before the Commonwealth Court of Pennsylvania	6, 7

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

No. 80-1303

THE POTOMAC EDISON COMPANY, *Appellant,*

v.

THE COMMONWEALTH OF PENNSYLVANIA, *Appellee.*

On Appeal From The Supreme Court Of Pennsylvania

APPELLANT'S BRIEF OPPOSING MOTION TO DISMISS OR AFFIRM

ARGUMENT

The Equal Protection Argument, Which Is A Substantial Federal Question, Is Properly Before The Supreme Court Of The United States.

Appellant erroneously argues that, even if the Court finds that a substantial federal question is raised, the appeal should be dismissed because the federal question was not preserved properly. Appellant's argument is in-

apposite. *Great Northern Railway Co.* v. *Sunburst Oil & Refining Co.*, 287 U.S. 358, 363, 366-367 (1932); *Cumberland Coal Co.* v. *Board of Revision, Etc.*, 284 U.S. 23, 24-25 (1931).

The substantial federal question before this Court was raised in paragraph 4 of Appellant's application for reargument which was filed with the Supreme Court of Pennsylvania. In its application for reargument, Appellant contended, *inter alia*:

> "4. As a matter of law and fundamental fairness, Appellant is entitled to have its appeal adjudged by the same definition of the term 'manufacturing' as consistently applied by your Honorable Court to past tax litigants and as repeatedly accepted by the General Assembly in sessions, spanning more than 50 years. By failing to adjudge Appellant's claim according to its judicial definition of 'manufacturing', your Honorable Court failed to apply uniformly the manufacturing exemption from franchise tax in violation of Article IX, Section 1 of the Pennsylvania Constitution, and also deprived Appellant equal protection of law in violation of Section 1 of the Fourteenth Amendment to the United States Constitution. Affirming the Order of the Commonwealth Court imposes a greater franchise tax liability against Appellant than against other taxpayers whose franchise tax liability, and exemption therefrom under the manufacturing exemption, were previously adjudged by your Honorable Court under its judicial definition of 'manufacturing'."

Appellant was not able to raise this question until its application for reargument.

The federal question arose from the decision of the Supreme Court of Pennsylvania to adjudge Appellant's claim to the manufacturing exemption from Pennsylvania franchise tax by a different definition of the

term "manufacturing" than uniformly applied for over 50 years to all other taxpayers, foreign and domestic, which claimed the exemption from franchise tax and capital stock tax, since no basis exists for the difference and the Pennsylvania Supreme Court stated no reason for the difference.

Because the capital stock tax and franchise tax legislation contains no definition of the term "manufacturing", the Supreme Court of Pennsylvania judicially defined that term over 50 years ago. Without reason and without explanation, the Commonwealth Court of Pennsylvania departed from the judicial definition of the term. Jurisdictional Statement at 14-19. Because the Supreme Court of Pennsylvania, as the ultimate arbiter of Pennsylvania law, judicially pronounced the definition of the term "manufacturing", Appellant sought that Court's decision to correct the lower Court's improper departure from the judicial definition. The Supreme Court of Pennsylvania failed to do so, issuing only a *per curiam* Order affirming the decision of the Commonwealth Court of Pennsylvania, the lower court. Neither the Supreme Court of Pennsylvania nor the Commonwealth Court of Pennsylvania explained the departure from the definition in Appellant's case, although Appellee's persistent, improper remarks[1] about the admittedly adverse fiscal impact on the Commonwealth of Pennsylvania if Appellant receives the manufacturing exemption appear to have influenced the Pennsylvania Supreme Court's decision to affirm without issuing an opinion.

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[1] Appellant repeatedly objected and excepted to these remarks at trial and at oral argument. *E.g.*, Exceptions ¶ 12; Motion to Dismiss or Affirm at 24.

The Supreme Court of Pennsylvania failed to indicate whether the judicial definition of the term "manufacturing" was overruled or modified. The *per curiam* opinion of the Supreme Court of Pennsylvania presented Appellant with its first opportunity — by application for reargument — to raise the federal question involved in this appeal. Appellant did so in paragraph 4 of its application for reargument. The Supreme Court of Pennsylvania denied the application for reargument. If, as in the instant case, the decision of the state supreme court supplies a new basis for the defeated party's claiming the denial of a federal right, then the general rule cited by Appellee in its motion[2] is not applicable. *Great Northern Railway Co., supra.* Without any explanation, the Supreme Court of Pennsylvania failed to apply to Appellant's claim its own case law defining the term "manufacturing" for the purposes of the manufacturing exemption from franchise tax and capital stock tax. In so acting, the Supreme Court of Pennsylvania, itself, created, for the first time in this case, the federal question before this Court. Under similar circumstances, the *Great Northern* Court ruled:

> "The rule, general as it is, does not extend to cases where the constitutional question, however tardily raised, is considered and decided (*Consolidated Turnpike Co.* v. *Norfolk & O. V. Ry. Co.*, 228 U.S. 326, 334; *Cumberland Coal Co.* v. *Board*, 284 U.S. 23), nor does it apply where the grounds of the decision supply a new and unexpected basis for a claim by the defeated party of the denial of a federal right. *Brinkerhoff-Faris Trust & Savings Co.* v. *Hill*, 281 U.S. 673, 678; *Missouri ex rel. Missouri Insurance Co.* v. *Gehner*, 281 U.S. 313, 320; *American Surety Co.* v. *Baldwin, supra.*

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[2] Appellee's Motion to Dismiss or Affirm at 17-19.

> This case is clearly with the second of these exceptions, if it is not also within the first. We have seen that the assault upon the judgment is made along two lines. The first is a challenge to the constitutional validity of the ruling in the *Doney* case, and involves a misconception of the decision in *Arizona Grocery Co.* v. *Atchison, T. & S. F. Ry. Co., supra.* The second is a *challenge to the constitutional validity of the ruling in this case whereby the statute is adjudged to mean one thing for some cases and another thing for others. This latter objection the petitioner could not make in advance of the event.* 287 U.S. at 367 (Emphasis added).

Moreover, as in the instant case, if the federal question is raised by application or petition for reargument to the state supreme court and the state supreme court rejects the federal question, then the general rule cited by Appellee also is inapplicable, regardless of when the federal question might have been raised in the state proceedings. *Great Northern Railway Co., supra; Cumberland Coal Co., supra.* In *Cumberland,* the taxpayer first raised the federal question by petition for reargument (now known as an application for reargument) filed with the Supreme Court of Pennsylvania. The petition for reargument was denied, rejecting the federal question. The taxpayer could have raised the federal question at any time in the state proceeding before filing its petition for reargument. Noting this exception to the general rule, the Supreme Court of the United States heard the case on the federal question, reversing the Pennsylvania Supreme Court. 284 U.S. at 24-30. This exception also applies at bar.

Appellant raised the federal question in its exceptions filed in the Commonwealth Court of Pennsylvania, by excepting to that Court's failure to apply to Appellant's claim the judicial definition of the term

"manufacturing" as applied to franchise and capital stock taxpayers in other Pennsylvania cases. Exceptions ¶¶ 3, 4, 5; Motion to Dismiss or Affirm at 21-22. Appellant sought to have the Pennsylvania Supreme Court correct this error, because that Court established the definition more than 50 years ago and thereafter applied the definition uniformly to all taxpayers claiming the manufacturing exemption, except Appellant. Instead, the Pennsylvania Supreme Court unexpectedly ignored the error without offering any reason for doing so.

Pennsylvania Courts Have Not Followed The Definition Which Was Used To Deny Appellant's Claim To The Manufacturing Exemption.

In denying Appellant's claim to the manufacturing exemption, the Commonwealth Court of Pennsylvania grafted to the judicial definition of the term "manufacturing" a requirement that "molecules of the original raw material survive in the final product". 411 A.2d at 1290, 1291: Jurisdictional Statement at 12a (Appendix C). Before and after the decision in Appellant's case, this requirement was not part of the judicial definition of the term "manufacturing". Jurisdiction Statement at 14-20, 23a-24a (Appendix F); *Kirks Milk Products, Inc.* v. *Commonwealth of Pennsylvania*, No. 1443 Commonwealth Docket 1976, before the Commonwealth Court of Pennsylvania (opinion filed April 3, 1981.[3] In *Kirks Milk*, the Commonwealth Court of Pennsylvania, without referring to its *Potomac Edison* opinion, held that a taxpayer's operations in producing skim milk powder and buttermilk powder by evaporation qualify for the manufacturing exemption. Although the *Kirks*

[3] The *Kirks Milk* Opinion is reproduced, in its entirety, *infra*, in Appendix A.

Milk Court noted that the judicial definition was derived more than 50 years ago, the Court made no reference to any supposed requirement that "molecules of the original raw material survive in the final product" in order to qualify for the manufacturing exemption under that definition.

The *Kirks Milk* opinion was issued on April 3, 1981. Research reveals that *Kirks Milk* is the only manufacturing exemption case decided by Pennsylvania courts after *Potomac Edison.*

CONCLUSION

For the foregoing reasons, Appellee's motion to dismiss or affirm must be denied; probable jurisdiction should be noted; and the order of the Supreme Court of Pennsylvania must be reversed.

Respectfully submitted,

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APPENDIX

IN THE COMMONWEALTH COURT
OF PENNSYLVANIA

No. 1443 C.D. 1976

KIRKS MILK PRODUCTS, INC., *Petitioner*

v.

COMMONWEALTH OF PENNSYLVANIA, *Respondent*

BEFORE: HONORABLE JAMES C. CRUMLISH, *President Judge*
HONORABLE ROY WILKINSON, JR. *Judge*
HONORABLE GLENN E. MENCER, *Judge*
HONORABLE THEODORE D. ROGERS, *Judge*
HONORABLE DAVID W. CRAIG, *Judge*
HONORABLE ROBERT W. WILLIAMS, JR., *Judge*
HONORABLE MADALINE PALLADINO, *Judge*

ARGUED: December 9, 1980

OPINION

Opinion by President Judge Crumlish Filed: April 3, 1981

Kirks Milk Products, Inc., appeals from a Board of Revenue and Finance determination that the production of skim milk powder and buttermilk powder does not constitute "manufacturing"[1] or "processing"[2] within the capital stock tax exemption. We reverse.

The stipulated facts follow: Kirks Milk Products, Inc. (Taxpayer) is a Pennsylvania corporation engaged in the storage, production, and wholesale-retail purchase and sale of milk, cream, butter, cheese and, for our purposes, buttermilk powder and skim milk powder. The taxpayer's total *powdered* dairy products output, approximately 91% powdered skim milk and 9% powdered buttermilk, is sold at wholesale and constitutes $566,008 and $54,041, respectively, of $1,763,880 in total gross receipts[3] for the tax period, November 1, 1973 through October 31, 1974.

Filing its Capital Stock Tax Report to reflect tax liability of $207.11, taxpayer asserted that buttermilk and skim milk powders were produced through "manufacturing," concluded that receipts therefrom were derived from the use of exempt assets, and reported its tax liability based only upon its non-manufacturing gross receipts or the raw milk purchased and resold at wholesale. However, the Department of Revenue settled the capital stock tax liability in the amount of $1,201.48 by denying exempt status for certain assets and adding in gross receipts for skim milk powder, buttermilk powder, and cream to taxable assets.

Since the sole question involved in this case is whether Taxpayer's production of buttermilk powder and skim milk powder constitutes "processing" or manufacturing" for purposes of exemption under Article VI of the Tax Reform Code of 1971, a discussion of the legal background will be followed by a detailed review of the production process.

Discussion

For nearly 100 years, the assets of Pennsylvania corporations engaged in manufacturing have enjoyed an exemption from capital stock taxation. *See Norris Brothers* v. *The Commonwealth*, 27 Pa. 494 (1856). More recently, our Supreme Court in *Commonwealth* v. *Deitch Co.*, 449 Pa. 88, 94, 295 A.2d 834, 838 (1972), expressed the purpose of the manufacturing exemption as created "to establish a favorable climate in Pennsylvania for manufacturers and thus encourage the development of industry. Additionally, there was a desire not to put domestic manufacturers at a competitive disadvantage with out of state industries[,]" who enjoyed tax exempt status in their adjoining home states. *And see Commonwealth* v. *Northern Electric Light and Power Co.*, 145 Pa. 105, 120, 22 A. 839, 841 (1891).

Since the tax laws fail to provide definitional guidelines, the judicial meaning and the corresponding practical interpretation of the term "manufacturing" becomes most impor-

tant. In *Armour and Co.* v. *Pittsburgh*, 363 Pa. 109, 116, 69 A.2d 405, 408-09 (1949), our Supreme Court summarized business activities which qualify for the exemption:

> It was said in *Commonwealth* v. *Weiland Packing Co.*, 292 Pa. 447, 450, 451, 141 A. 148, 149, that 'the process of manufacture brings about the production of some new article by the application of skill and labor to the original substance or material out of which such new product emerges. If however there is merely a superficial change in the original materials or substances and no substantial and well signalized transformation in form, qualities and adaptability in use, quite different from the originals, it cannot properly and with reason be held that a new article or object has emerged — a new production been created.' Nor is it of legal significance in this connection that the operations thus conducted require large and extensive plants and organizations, trained men and intricate machinery, for even though the labor be skilled, the operations delicate, a large plant involved, and expensive machinery utilized, such factors, neither individually nor collectively, covert what is essentially a mere processing operation into a manufacturing one: of, *Rieck-McJunkin Dairy Co.* v. *Pittsburgh School District*, 362 Pa. 13, 23, 66, A. 2d 295, 299.

Over the years, our courts have not only been consistent in narrowly defining the term "manufacture", but reluctant to grant the manufacturing exemption with respect to operations performed by taxpayers in the production of foods. Early on our Supreme Court held that the purchase, slaughter, cleaning, washing, sorting and resale of meat, hides, heads, and horns was not manufacturing within the capital stock tax exemption. *Commonwealth* v. *Consolidated Pressed Beef Co.*, 242 Pa. 163, 88 A.975 (1913). *See also Commonwealth* v. *Weiland Packing Co.*, 292 Pa. 447, 141 A. 148 (1928), where "manufacturing" status was denied pickled and dry salt pork, smoked hams and other pressed meat products.

A number of years later, the Supreme Court addressed the "manufacturing" status of milk products. In *Rieck-McJunkin Dairy Co.* v. *Pittsburgh School District*, 362 Pa. 13, 66 A.2d 295 (1949), the milk dealers' status as "manufacturers" under the mercantile tax exemption was questioned with respect to the production of pasteurized and homogenized milk and cream, butter, pasteurized cultured buttermilk, pasteurized skimmed milk, and our subject, skimmed milk powder. Classifying the milk dealers as manufacturers with respect to making ice cream, cottage cheese, and butter, our Supreme Court held that "[w]hile these articles are made from milk, they are 'a new and different article' from the milk originally purchased," but concluded that "[c]ondensed, evaporated and powdered milks are produced by boiling off, under controlled conditions, a portion of the water content of the milk; this is a variation of the process of reducing a raw material to its constituent parts for purposes of distribution." *Id.* at 22-23, 66 A.2d at 299.

However, certain methods of food production have fared well. In *Commonwealth*, v. *Snyder's Bakery*, 348 Pa. 308, 35 A.2d 260 (1944), the taxpayer's production of potato chips from raw whole potatoes, hot fat, vegetable oils, and salt constituted "manufacturing" for mercantile license tax purposes. The Court held that the manufacure of potato chips, consisting of storing raw potatoes at a given temperature for a specified period, testing, storing at increased temperature, cleaning, slicing, washing, drying, immersing in hot fat and vegetable oils, draining and drying, and salting and packaging, resulted in a product adapted to an entirely different use from the raw potato, the form and content of the finished product being entirely different.

In *Pillsbury Mills, Inc.* v. *Pittsburgh School District*, 408 Pa. 369, 372, 184 A.2d 236, 237 (1962), the milling of wheat into flour was held to be "manufacturing" for mecrcantile license tax purposes — "an intricate technologically sophisticated process. . . . The milling operation includes the

grinding, blending and processing of the many types of wheat into flour of varying characteristics which will be used for countless purposes."

Even in the case of *Commonwealth* v. *Berio Vending Co.*, 415 Pa. 101, 105-06, 202 A.2d 94, 96 (1964), where the production of popcorn was denied manufacturing status for franchise tax exemption purposes, the Supreme Court after discussion drew an important distinction:

> "[T]he production of popcorn, even though on an expanded scale, should not achieve the status of manufacturing as that term is popularly considered. The popping of corn does not require any sepcific skill or elaborate machinery. It can be done in the home by a child in a smaller scope in the same manner as appellant accomplishes in its plant. There is no application of labor, skill, art or science to provide a well signalized change as those terms are known. There can be little doubt that the courts have required a certain degree of skill, art or science be employed.
>
> * * *
>
> While the court below expressed doubt as to the current validity of the Snyder's Bakery case, we need express no view as to that observation. *It is quite clear that the production of popcorn involves far less control factors, skill and science* than does the production of potato chips." (footnote omitted) (emphasis added).

Consequently, we must examine the production methods used for both buttermilk and skim milk powders, and ascertain first, that a high degree of skill, science and labor has been applied to the liquid buttermilk and skim milk, and second, that a substantial transformation in form, qualities and adaptability in use has made the powdered milk a new, different and useful article.

Aside from arguing that the taxpayer's operation does not constitute "processing" within that added statutory exemption, the Commonwealth contends that the simple extrac-

tion of water has neither popularly nor judicially been regarded as manufacturing. *See Rieck-McJunkin Dairy Co.* v. *Pittsburgh School District, supra* (milk products); *Commonwealth* v. *Glendora Products Co.*, 297 Pa. 305, 146 A.896 (1929) (roasting coffee), and *Commonwealth* v. *Babcock Lumber Co.*, 1 Pa. Commonwealth Ct. 45, 272 a.2d 522 (1971) (kiln drying pre-cut green lumber). While the production of powdered milk is clearly not "processing" within the exemption, we must disagree with the Commonwealth's "manufacturing" position.

In the *Rieck-McJunkin* case, our Supreme Court seems to have had no informed opportunity to examine evidence regarding either the taxpayer's machinery or production methods or the distinctive characteristics of the subject powdered milk. Although evidence was produced by the taxpayer, the chancellor made no findings of fact with respect to the taxpayer's production methods. In addition, the *Rieck-McJunkin* decision has lost much of its impact upon milk products in light of the recent processing exemption to the capital stock tax. As for *Glendora Products, supra,* and *Babcock Lumber, supra,* the manufacturing processbefore us goes far beyond roasting coffee and drying out lumber.

A. Skill, Science and Labor

Taxpayer utilizes an elaborate "Lo-Temp" evaporation system with a three-cycle process, identified by refrigeration, product, and spray drying stages, in the production of buttermilk and skim milk powders.

Operating on the evaoration principle, the initial "refrigeration" cycle removes water from the milk by using two vacuum chambers through which tubes carrying pressurized ammonia vapors act as a heating agent. These "first effect" and "second effect" chambers work hand in hand to create a condensed or concentrated, but still liquid, buttermilk or skim milk product. In the "first effect" chamber, since the milk is vacuum heated over the ammonia vapor tubes,

evaporation of the water content occurs at a relatively low temperature. The water vapor extracted from milk in the "first effect" chamber is then utilized as the heating agent in the "second effect" chamber, where the milk product is heated to a higher temperature under a vacuum and is concentrated or condensed still further as additional water is removed by evaporation.

In the second or "product" cycle of the Lo-Temp system, partially concentrated liquid buttermilk or skim milk products from the "second effect" chamber are pumped back into the "first effect" chamber. As the product flows down the tubes of the "first effect" chamber, its temperature is increased to between 165°F/73.9°C and 185°F/85°C, and additional water is removed by evaporation and pumped off by a condensate pump. Completion of this "product" cycle leaves a product which contains 42% to 48% milk solids by volume. Attendant are various physical and extremely complicated chemical changes in the liquid skim milk and liquid buttermilk as a result of the heating and concentration which took place during the "refrigeration" and "product" cycles. Serum proteins and cascine are denatured, the acidity of the product changes due to changes in chemical salt balances, the "heat stability" of the product is increased, and the product becomes increasingly viscous or "sticky."

The final stage of skim and buttermilk powder production is identified as the "Spray Drying" Cycle. The heated and concentrated product is forced at high pressure through an atomizing nozzle located at the top of a precipitating chamber. The atomized particles or droplets are exposed to a controlled air flow heated by a direct fired furnace, and upon reaching a temperature of 185°F/85°C, instantly release their remaining water content in the form of vapor. Dry buttermilk or skim milk particles, separate from but mixed with water vapor, pass into the primary collector where they are separated by "cyclonic" action. The powder is further cooled by air as it passes progressively through secondary and final production collectors and is finally sifted and placed in sealed containers.

Surely, that degree of skill, science and labor which "manufactured" potato chips in *Snyder's Bakery* and flour in *Pillsbury Mills* can be attributed to the elaborate Lo-Temp evaporation systems's three cycle production of buttermilk and skim milk powders.

B. New, different and useful product

Addressing the second prong of the "manufacturing" test, we conclude that resulting buttermilk and skim milk powders are new and useful product, substantially different in form, qualities and adaptability in use. In "form," the conversion from liquid to crystalline or solid is obvious. In terms of "qualities" and "adaptability in use," the record and stipulated facts speak for themselves. Aside from the "lactose" or crystalline reaction and the "browning" or chemical heat reactions, the resulting powders have almost indefinite "keeping" qualities, none of the coagulent, curding or enzyme properties, increased blending ability and greater flavor stability than do either buttermilk or skim milk. The principal commercial uses of buttermilk and skim milk powder are as ingredients in special dried foods and prepared dry mixes such as dry cake or biscuit mixes, dry soup mixes, prepared dry cereals, dry infant formulas and prepared dry dog and other animal foods, where it is not possible to use the liquid milks. Buttermilk and skim milk products are used extensively in the baking and confection industries as ingredients because of their unique ability to blend with sugar and cane syrups and flavorings at high processing temperatures without coagulating or resulting in undesirable flavor characteristics. Liquid milks have been found commercially infeasible because of such undesirable characteristics as flavor changes, inability to withstand the high cooking temperatures required coagulation or curding and the inability to produce a smooth viscous mixture of the candy product. Buttermilk and skim milk powders are also used extensively in virtually all areas of the prepared food industry in products such as canned or frozen soups, frozen dinners, frozen casseroles, meat sausages, canned meats, and canned gravies and sauces because of their

superior "keeping" characteristics, blending characteristics and flavor stability. In addition, aside from general use in the production of glue and adhesive materials, the powdered milks may be "reconstituted" and used as a beverage for human consumption with characteristics quite different from their liquid counterparts.

Having determined that taxpayer is entitled to the capital stock tax's manufacturing exemption for the fiscal year ending October 31, 1974, we reverse the decision and order of the Board of Finance and Revenue, and enter judgment in accordance with stipulation of Fact 41 in favor of the Commonwealth and against taxpayer in the amount of $207.11. The judgment shall be marked "satisfied" upon payment of docket costs by taxpayer and a credit of $994.37 shall be entered in favor of taxpayer on the proper books and records of the Department of Revenue.

Reversed.

Date: April 3, 1981 /s/ JAMES C. CRUMLISH
James C. Crumlish
President Judge

Judges Wilkinson, Jr., and Rogers dissent.

This decision was reached prior to the expiration of the term of Judge Wilkinson, Jr.

FOOTNOTES

[1] Section 602(a) of the Tax Reform Code of 1971, Act of March 4, 1971, P.L. 6, *as amended*, 72 P.S. §7602(a), provides in pertinent part:

> (a) That every domestic corporation . . . shall be subject to, and pay into the treasury of the Commonwealth annually, through the Department of Revenue, a tax at the rate of ten mills, upon each dollar of the actual value of its whole capital stock of all kinds . . . *provided, That the provisions of this section shall not apply to the taxation of the capital stock of corporations, limited partnerships and joint-stock associations organized for manufacturing, processing, research or development purposes,* which is invested in and actually and exclusively employed in carrying on manufacturing, processing, research or development within the State . . . . (Emphasis added.)

[2] Section 602(c)(7), 72 P.S. §7602(c)(7), specifically provides a "processing" exemption to the capital stock tax:

> (c) The term processing, as used in this section, shall mean and be limited to the following activities when engaged in as a business enterprise:
>
> * * *
>
> (7) The production, processing and bottling of nonalcoholic beverages for wholesale distribution.

The exemption did much to alleviate the restrictive interpretation which had been placed upon "manufacturing" specifically relative to milk products. *See Rieck-McJunkin Dairy Co.* v. *Pittsburgh School District*, 362 Pa. 13, 66 A.2d 295 (1949).

Taxpayer's total gross receipts of $1,763,880 during the taxable period were derived from the sale of raw milk purchases and resold at wholesale ($315,892), cream ($123,698), butter ($175,161) and cheese ($529,080), buttermilk powder ($54,041) and skim milk powder ($566,008). [*sic*]

[4] [*sic*] For background purposes, we note that the exempt "processing" of separated and pasteurized liquid cream and skim milk occurs in two stages. In the initial stage of production, the "separation phase," raw whole milk is heated in large tanks, pumped into a continuous centrifuge, and separated into it constitutent parts — liquid skim milk and liquid cream. The second stage or "pasteurization phase" finds both the milk and cream heated under controlled conditions in a pasteurizer in order to retard the fermentation of milk sugars, prevent the formation of toxic substances, and generally destroy harmful bacteria.

The pasteurized cream is then utilized to produce butter and buttermilk through a third stage, an agitaiton or "churning process." Here, liquid cream containing 30% to 33% butter fat is placed in a low temperature mechanical churn and rotated until the "breaking point" is reached and butter "granules" are formed. Thin production of butter indisputably constitutes "manufacturing" within the scope of the capital stock tax exemption. However, the remaining liquid, a by-product of butter production, is drawn off and subsequently used in the production of buttermilk powder.

Taxpayer's entire production of liquid buttermilk and skim milk is then completely utilized in the production of buttermilk and skim milk powders.

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

No. 1443 C.D. 1976

KIRKS MILK PRODUCTS, INC., *Petitioner*

v.

COMMONWEALTH OF PENNSYLVANIA, *Respondent*

ORDER

The Board of Finance and Revenue order, dated July 30, 1976, Board Docket No. R-1610, is hereby reversed, and judgment is directed to be entered in accordance with Stipulation of Fact 41 in favor of the Commonwealth and against Kirks Milk Products, Inc. in the amount of $207.11. The judgment shall be marked "satisfied" upon payment of docket costs by taxpayer and a credit of $994.37 shall be entered in favor of taxpayer on the proper books and records of the Department of Revenue unless exceptions are filed hereto within thirty [30] days.

Dated April 3, 1981 /s/ JAMES C. CRUMLISH,
James C. Crumlish,
President
Judge

FRANCIS C. BARBUSH
Cheif Clerk